No. 91-1135-CFX
Status: GRANTED

Title: Newark Morning Ledger Co. as successor to The Herald Company, Petitioner
v.
United States

Docketed:
January 13, 1992

Court: United States Court of Appeals for the Third Circuit

Counsel for petitioner: Bork,Robert H.

Counsel for respondent: Solicitor General

Entry	Date	Note	Proceedings and Orders
1	Jan 13 1992	G	Petition for writ of certiorari filed.
4	Feb 6 1992		Brief amici curiae of Pennsylvania Petroleum Association, et al. filed.
3	Feb 11 1992		Order extending time to file response to petition until March 16, 1992.
8	Feb 11 1992		Brief amicus curiae of Magazine Publishers of America, Inc. filed.
5	Feb 12 1992		Brief amici curiae of Independent Insurance Agents of America, et al. filed.
6	Feb 12 1992		Brief amicus curiae of American Newspaper Publishers Association filed.
7	Feb 13 1992		Brief amicus curiae of American Bankers Association filed.
9	Mar 16 1992		Brief of respondent United States filed.
10	Mar 18 1992		DISTRIBUTED. April 3, 1992
11	Apr 6 1992		Petition GRANTED.
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13	Apr 30 1992		Order extending time to file brief of petitioner on the merits until June 5, 1992.
14	May 29 1992		Brief amicus curiae of Tax Executives Institute filed.
15	Jun 2 1992		Brief amicus curiae of Colorado National Bankshares, Inc. filed.
17	Jun 3 1992		Brief amicus curiae of Magazine Publishers of America, Inc. filed.
16	Jun 4 1992		Brief amicus curiae of Donrey, Inc. filed.
18	Jun 4 1992		Brief amici curiae of Independent Insurance Agents of America, et al. filed.
19	Jun 4 1992		Brief amicus curiae of Investment Counsel Association of America filed.
20	Jun 4 1992		LODGING consisting of 10 copies of a document submitted by amicus,Investment Counsel Assn. of America, received.
21	Jun 5 1992		Brief amicus curiae of Worrell Enterprises, Inc. filed.
22	Jun 5 1992		Brief amici curiae of Black & Decker, et al. filed.
23	Jun 5 1992		Brief amicus curiae of Newspaper Association of America filed.
24	Jun 5 1992		Joint appendix filed.
25	Jun 5 1992		Brief of petitioner Newark Morning Ledger filed.
26	Jun 5 1992		Brief amici curiae of New England Fuel Institute, et al. filed.
27	Jun 5 1992		Brief amicus curiae of Philip Morris Companies filed.
28	Jun 5 1992		Brief amicus curiae of American Business Press filed.
29	Jun 5 1992		Brief amici curiae of Frederic W. Hickman, et al. filed.

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Entry	Date	Note	Proceedings and Orders
31	Jun 5 1992		Brief amicus curiae of Charles Schwab Corporation filed.
33	Jun 5 1992		Brief amicus curiae of American Bankers Association filed.
34	Jun 5 1992		Brief amicus curiae of Coopers & Lybrand filed.
32	Jun 11 1992		Record filed.
		*	Original proceedings U. S. District Court, District of New Jersey.
35	Jun 16 1992		Record filed.
		*	Partial proceedings U. S. Court of Appeals, Third Circuit (1 Box)
37	Jul 1 1992		Order extending time to file brief of respondent on the merits until August 5, 1992.
38	Aug 5 1992		Brief of respondent United States filed.
39	Aug 10 1992		CIRCULATED.
40	Aug 21 1992		SET FOR ARGUMENT TUESDAY, NOVEMBER 10, 1992. (1ST CAES).
41	Sep 4 1992	X	Reply brief of petitioner filed.
42	Nov 10 1992		ARGUED

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No. 91-1135

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTION PRESENTED

1. Whether the Third Circuit, in acknowledged conflict with other circuits and the United States Tax Court, was correct that under the Internal Revenue Code an income-producing wasting intangible asset may be nondepreciable "goodwill" as a matter of law.

PARTIES TO THE PROCEEDING

Petitioner, plaintiff in the district court and appellee in the court of appeals, is Newark Morning Ledger Co.* Respondent is the United States of America.

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* The parent company of petitioner Newark Morning Ledger Co. is Advance Publications, Inc. Subsidiaries or companies in which Newark Morning Ledger Co. owns a significant interest (other than wholly owned subsidiaries) are Crown Outlet Holding Corp., Business People Publications Limited, Condé Nast and National Magazine Distributors Limited, Wagadon Limited, Barrie & Jenkins Limited, Frampton Flora Limited, Triad Paperbacks Limited, Constable & Company Limited, Watchword plc, Andersen Press Limited, and Vision Cable of Pinellas, Inc.

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IN THE

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OCTOBER TERM, 1991

No. ____

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Newark Morning Ledger Co. hereby petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The opinion of the Third Circuit, as amended, is reported at 945 F.2d 555 (3d Cir. 1991), and is reprinted in the Appendix hereto at 1a-30a.[1] The opinion of the United States District Court for the District of New Jersey is reported at 734 F. Supp. 176 (D. N. J. 1990), and is reprinted in the Appendix at 31a-51a.

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[1] References to the Appendix to this Petition are cited herein as "App. at ___ a."

JURISDICTION

The judgment of the Third Circuit was entered on September 12, 1991. Rehearing *en banc* was denied (Circuit Judges Greenberg and Nygaard dissenting) on October 15, 1991. (App. at 52a-53a). The Third Circuit stayed its mandate on November 14, 1991. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTE AND REGULATION INVOLVED

Section 167 of the Internal Revenue Code states in relevant part:

> (a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.
>
> . . . .

26 U.S.C. § 167(a) (1988).

The Treasury Regulation interpreting I.R.C. § 167(a) states in relevant part:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

Treas. Reg. § 1.167(a)-3 (1991).

STATEMENT OF THE CASE

This case presents a conflict among the circuits on a nationally-significant issue affecting billions of tax dollars. The issue concerns taxpayers' rights to depreciate intangible assets that are useful in their businesses for only a limited time. The court below held, as a matter of law, that customer relationships are nondepreciable "goodwill," even if they have determinable, limited durations and ascertainable values. (App. at 29a). That ruling calls into question the depreciability of over $10.5 billion of "customer/market-based intangible assets"; it affects the value of newspaper and magazine subscriptions, bank deposits, insurance relationships, and a host of other commercial and market relationships in seven major industry groups (manufacturing, finance/insurance/real estate, services, transportation, retail, wholesale trade, and mining). *See* United States General Accounting Office, *GAO/GCD-91-99 Tax Policy, Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets* (Aug. 1991) [hereinafter "GAO Report"], at 4, 20, 22, 28-29. The ruling below is in direct, acknowledged conflict with decisions in two other circuits and the United States Tax Court, resulting in differing treatment of identically-situated taxpayers. Moreover, because there are far more numerous and fundamental decisional conflicts than the court of appeals acknowledged, the magnitude of the problem is even greater. A uniform rule of decision is critical.

A. Statement of Facts

Petitioner Newark Morning Ledger Co. ("Morning Ledger") is a newspaper publisher that is the successor to The Herald Company ("Herald"). In 1976, Herald purchased all of the stock of Booth Newspapers, Inc.

("Booth"), a publisher of daily and Sunday newspapers in eight Michigan communities. On May 31, 1977, Booth was merged into Herald. This transaction required Herald to allocate its adjusted tax basis in the Booth stock among the Booth assets in proportion to their fair market values as of the date of the merger.

As the Internal Revenue Service ("IRS") and Morning Ledger later stipulated, the total fair market value of the Booth assets on May 31, 1977, was approximately $314 million. (App. at 36a). Approximately $224 million of the total fair market value was allocated among various financial, tangible and other assets, and approximately $90 million was allocated to intangible assets. Of the $90 million allocated to intangible assets, approximately $67 million was allocated to the "paid subscribers" of the eight Booth newspapers (App. at 47a-48a), and $23 million was allocated to the going concern value and goodwill value of the newspapers. This dispute centers on whether the $67 million value of the "paid subscribers" was depreciable.

The "paid subscribers" are an example of an asset commonly known as a "customer-based" intangible asset. *GAO Report* at 20-22.[2] The "paid subscribers" were those individually identified customers who, under terminable-at-will contracts with the papers, contracted for delivery of a newspaper to a specific address on a regular basis in return for payment of the subscription price. These customers comprised a category distinct from the unknown customers—those who purchased their newspaper from a newsstand, a coin box, or other outlet—and from customers who purchased advertising.

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[2] *See also* H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 936-37, *reprinted in* 1987 U.S.C.C.A.N. 2313-1245, 2313-1682-83; H.R. Rep. No. 391(II), 100th Cong., 1st Sess. 1058-59, *reprinted in* 1987 U.S.C.C.A.N. 2313-378, 2313-673-74.

Beginning in 1977, Herald claimed depreciation deductions with respect to the value of the paid subscribers. Herald did *not* claim depreciation deductions for any of the value of goodwill, which was comprised, *inter alia*, of the papers' name recognition, reputation, and relationships with non-subscription customers and customers who purchased advertising.[3] The IRS disallowed the claimed deductions, asserting that the paid subscribers were also part of the "goodwill" of the papers, and were therefore nondepreciable. Herald paid the additional taxes and interest, and Morning Ledger, as Herald's successor, filed a refund claim for the taxable years 1977 through 1980. When the IRS failed to act on the claim within the Code-prescribed period, Morning Ledger filed suit in the United States District Court for the District of New Jersey.

B. Proceedings Below

The case was tried to the district court on February 5 through February 8, 1990. From the outset, Morning Ledger and the government agreed that, under the widely followed two-pronged *Houston Chronicle* test,[4] in order to

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[3] In general, newspapers have two potential sources of revenue: paid circulation (*i.e.*, sales of the paper itself) and sales of advertising. Advertising sales account for either all (in the case of a free distribution paper) or the bulk (in the case of a paid circulation paper) of total revenue.

Approximately 80% of the total revenue of the Booth newspapers came from advertising sales. The remaining 20% of total revenue was made up of circulation revenue from the paid subscribers (approximately 85%) and circulation revenue from coin box, newsstand, and other sales. With respect to the non-subscription circulation revenue stream and the advertising sales revenue stream, since the "life" of a relationship with an unknown purchaser at a newsstand or coin box, or a particular advertiser, cannot be determined nor its value ascertained, the prospect for the continuation of such sales is goodwill and was, concededly, nondepreciable.

[4] *See Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1249-50 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

prevail Morning Ledger had to establish: (1) that the paid subscribers had limited useful lives, the duration of which could be estimated with reasonable accuracy; and (2) that the paid subscribers had an ascertainable value separate and distinct from goodwill. (App. at 32a).

Morning Ledger presented four witnesses, two of them experts, to prove that on May 31, 1977, the paid subscribers of the eight Booth newspapers had limited useful lives, the duration of which could be estimated with reasonable accuracy. The government offered no evidence to contest this testimony. Indeed, the government stipulated to the duration of the paid subscriber relationships in the event that the district court made certain predicate findings.[5] The district court made those findings, as well as the ultimate finding that Morning Ledger had proved that the paid subscribers had limited useful lives with determinable durations, satisfying the first prong of the two-part test for depreciability.[6]

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[5] Morning Ledger and the government stipulated to specific separate useful lives for both the daily subscriber relationships and the Sunday subscriber relationships for each of the eight Booth newspapers. The lives of these sixteen distinct subscriber relationships ranged from 14.7 to 23.4 years depending on the particular newspaper. (App. at 39a).

[6] Specifically, the district court stated:

> It is undisputed that all the paid subscribers of the Booth newspapers as of May 31, 1977 would, at some point in time, no longer be subscribers. . . . Subscribers are lost because of death, relocation, lack of reader time or interest, changing lifestyles, and other factors that are beyond the control of the newspapers. Also, subscribers are lost due to dissatisfaction with the product or service and for various other reasons, including competition from other media sources such as radio, television, magazines and other paid-circulation and/or free distribution newspapers.

(App. at 40a). The district court also found that the paid subscribers were not self-regenerating assets, meaning "there is no automatic replacement for a subscriber who terminates his or her subscription."

On the second inquiry—proof of an ascertainable value—Morning Ledger presented two additional expert witnesses who valued the paid subscribers. These experts utilized the "income method" of valuation. They calculated "the present value of the net revenue stream [the subscribers] would provide over their limited lives, i.e., the subscription revenue less the cost of collecting that revenue." (App. at 44a). The government asserted that the "cost method" was the only proper valuation technique. However, Morning Ledger's experts testified that use of the cost method was inappropriate in this case. The district court rejected the government's contention and found that the government's experts "were unqualified, valued the wrong asset [a customer list as opposed to the paid subscribers] and utilized inappropriate methodology." (App. at 43a).[7]

(App. at 40a). These facts distinguished the paid subscribers from goodwill, which "by definition, has an indefinite life . . . ." (App. at 45a).

[7] The fair market value of an asset is the price at which the asset would change hands between a hypothetical willing buyer and willing seller, neither being under any compulsion to buy or sell, and both parties having reasonable knowledge of the relevant facts. Three valuation techniques are generally used to determine fair market value: (1) the market method, (2) the cost method, and (3) the income method.

In this case, the data was not sufficient to utilize the market method, which requires a sufficient number of actual transactions in the asset to be valued. (App. at 42a). The income method that Morning Ledger's experts employed is, the district court found, "commonly used to value intangible assets of a going business, other than goodwill and going concern value." (App. at 43a). The district court also found that the income method "is, in fact, what buyers and sellers would utilize to determine the price at which these assets would change hands." (App. at 43a). The government's cost method essentially measured only the direct cost of compiling a list of names (*i.e.*, a customer list); it did not measure the value of the subscriber relationships. Morning Ledger's experts testified that the cost method accordingly was inappropriate, and the district court found the cost method "could not and should not be used to determine the fair market value of the paid subscribers of the Booth newspapers as of May 31, 1977." (App. at 43a). Because the government's method "totally ignore[d]" Morning Ledger's "sub-

Furthermore, the government "refused to provide contradictory expert valuation under the income method." (App. at 7a n.2). Accordingly, finding that the government "offered no competent evidence to the court upon which the court could base any finding to reduce [Morning Ledger's] evidence of valuation," and that Morning Ledger's methodology "was fully in accordance with generally accepted valuation principles," the district court adopted Morning Ledger's methodology and the $67 million valuation of the paid subscribers. (App. at 44a-45a).

The district court also found that the paid subscribers were intangible assets separate and distinct from goodwill:

> [P]aid subscribers are distinct from previous customers who may or may not return, who may buy more or less or nothing at all. They are identifiable; how long they will remain as subscribers can be predicted with reasonable accuracy; and their value can be measured with a fair degree of accuracy. It is these unique characteristics which separates them from general goodwill and permits of a separate valuation.

(App. at 45a). As the district court held, the differentiation between nondepreciable goodwill and the depreciable, customer-based intangible asset at issue here turned on a distinction between "a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity of future purchases cannot be predicted" and, in contrast, "subscribers who can be predicted to purchase the same item, for the same price on a daily basis." (App.

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stantial efforts and expenses . . . invested over the years in establishing those subscriber relationships" (App. at 43a), it undervalued the paid subscribers, and hence could not yield their fair market value. (App. at 43a-44a).

at 32a-33a).[8] The $67 million value allocated to the latter (the paid subscribers), was separate and distinct from the $23 million allocated to the former (goodwill and going concern value). Morning Ledger was, therefore, entitled to depreciate the value of the paid subscribers.

On September 12, 1991, the Third Circuit reversed. It held that the paid subscribers were not depreciable, notwithstanding the district court's findings that the paid subscribers had limited useful lives and an ascertainable value, making them separate and distinct from goodwill. Instead, seizing upon the notion that any asset that contributes to continued patronage is "inherently" goodwill, the Third Circuit found that certain customer-based intangible assets, including the paid subscribers here, are nondepreciable goodwill as a matter of law. Nevertheless, the Third Circuit suggested that had Morning Ledger valued the paid subscribers pursuant to the cost method, and not the income method, the paid subscribers somehow may have been transformed from nondepreciable goodwill into depreciable intangible assets.

In holding that the paid subscription relationships were not depreciable, the Third Circuit placed considerable emphasis on the fact that the subscriptions were not formally embodied in fixed-term contracts. The Third Circuit held that contractually-based patronage was not "goodwill," and observed that "if the subscribers were contractually obligated to continue subscribing for some period of time, Morning Ledger *clearly* would be permitted to depreciate the value of those contracts over that time period." (App.

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[8] Morning Ledger's evidence also established that in the newspaper business, goodwill and paid subscribers often exist separately. For example, a profitable free-distribution newspaper would have goodwill, but does not have any paid subscribers. Its goodwill is derived from advertisers, name recognition, place of distribution, and the like. Conversely, a newspaper could have paid subscribers but lack goodwill if it were bankrupt or unprofitable.

at 11a-12a) (emphasis added). The court distinguished Morning Ledger's paid subscribers on grounds that those relationships were terminable-at-will contracts. (App. at 12a). It did not explain, in a case where Morning Ledger had proved that the life of the relationships was limited, and the parties had stipulated their duration (factual findings left undisturbed), why there was a difference, for purposes of depreciability, between fixed-term contracts and terminable-at-will contracts with ascertainable lengths.

On October 15, 1991, the Third Circuit denied Morning Ledger's petition for rehearing and suggestion for rehearing *en banc*. Two Circuit Judges, Greenberg and Nygaard, dissented.

REASONS FOR GRANTING THE PETITION

This case merits review because the Third Circuit, in acknowledged and direct conflict with other circuit courts and the Tax Court, has adopted a rule of law that transforms a large class of wasting intangible assets into nondepreciable "goodwill." The assets, worth billions of dollars, were heretofore widely held depreciable. Accordingly, this new legal rule produces differing tax treatment of identically-situated taxpayers.

The writ should be granted for three reasons. *First*, the Third Circuit's decision has resulted in a split among the circuit courts concerning the basic test for determining whether an intangible asset is depreciable or is instead nondepreciable goodwill. It has also created a direct and acknowledged split in the circuits on the depreciability of the customer-based intangible assets at issue in this case. As a result, there is uncertainty as to whether a host of intangible assets, long-recognized to be depreciable, are

now *per se* nondepreciable goodwill, despite the taxpayer's ability to prove that they are truly wasting assets.[9]

Second, the Third Circuit's error is a matter of substantial national significance. A nationwide General Accounting Office study indicates that as of 1989, in audited matters alone, taxpayers across the country had claimed depreciation deductions for $10.5 billion in customer-based and market-based intangible assets, and that the IRS had proposed adjustments in hundreds of such cases, aggregating over $4 billion in taxes. *GAO Report* at 22. If left unreviewed, the conflicts resulting from the Third Circuit's decision infect these cases and countless other transactions involving billions of dollars with uncertainty. If left unresolved, the conflicts ensure differential treatment of taxpayers from circuit to circuit, with enormous financial and legal consequences. It is crucial for the proper and consistent administration of the nation's revenue laws that this Court grant the petition and review the judgment below.

Third, in radically expanding the concept of goodwill to bar the depreciation of certain wasting assets, the Third Circuit has contravened the basic tax principle embodied in Section 167 of the Internal Revenue Code and the interpreting regulation that wasting assets *shall* be depreciable. Goodwill has long been held to be nondepreciable precisely because it is *not* a wasting asset—that is, it has an indefinite life. The Third Circuit's decision abandons this principle by radically expanding the concept of non-

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[9] It is well-established that uniformity among the circuits in tax cases is especially important in order to ensure predictable and equal administration of the federal income tax system. *See, e.g., United States v. Gilbert Assocs., Inc.*, 345 U.S. 361, 364 (1953); *Unger v. Commissioner*, 936 F.2d 1316, 1320 (D.C. Cir. 1991); *Nickell v. Commissioner*, 831 F.2d 1265, 1270 (6th Cir. 1987); *First Charter Fin. Corp. v. United States*, 669 F.2d 1342, 1345 (9th Cir. 1982).

depreciable "goodwill" to include intangible assets "notwithstanding that they have wasting lives." (App. at 29a).[10]

I.

CERTIORARI SHOULD BE GRANTED TO RESOLVE THE CONFLICT AMONG THE CIRCUITS REGARDING THE STANDARD FOR DEPRECIABILITY OF INTANGIBLE ASSETS UNDER THE INCOME TAX LAWS.

Section 167(a) of the Internal Revenue Code allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property, both tangible and intangible, used in a trade or business. Treasury Regulation 1.167(a)-3 identifies the circumstances under which an intangible asset may be depreciated:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited

[10] Moreover, not since the days of Prohibition has this Court addressed the issue of goodwill under the nation's revenue laws. *See Gambrinus Brewery Co. v. Anderson*, 282 U.S. 638, 641-44 (1931); *Clarke v. Haberle Brewing Co.*, 280 U.S. 384, 386-87 (1930). Not surprisingly, the longstanding confusion concerning the relationship between the depreciation of intangible assets and nondepreciable goodwill under the Internal Revenue Code has produced considerable commentary. *See, e.g.*, Danny P. Hollingsworth and Walter T. Harrison, *Taxation of Intangibles*, 9 J.L. & Com. 51 (1989); George Mundstock, *Taxation of Business Intangible Capital*, 135 U. Pa. L. Rev. 1179 (1987); Lawrence M. Dubin, *Allocation of Costs to, and Amortization of, Intangibles in Business Acquisitions*, 57 Taxes 930 (1979); Martin J. Gregorcich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 Tax Law. 251 (1975); Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 Harv. L. Rev. 859 (1968); Alan S. Schenk, *Depreciation of Intangible Assets: The Uncertainty of Death and Taxes*, 13 Wayne L. Rev. 501 (1967); Robert J. McDonald, *Goodwill and the Federal Income Tax*, 45 Va. L. Rev. 645 (1959); Note, *An Inquiry Into the Nature of Goodwill*, 53 Colum. L. Rev. 660 (1953); Floyd A. Wright, *The Nature and Basis of Legal Goodwill*, 24 Ill. L. Rev. 20 (1929).

> period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are copyrights and patents.

Because it is universally accepted that goodwill is not "of use . . . for only a limited period," but instead has an indefinite life,[11] Treasury Regulation 1.167(a)-3 also provides that goodwill is not depreciable.

Prior to the Third Circuit's decision, it was uniformly recognized that whether a particular intangible asset is depreciable under Section 167(a) of the Internal Revenue Code turned on whether the taxpayer can establish that the asset has an ascertainable value separate and distinct from goodwill; and has a limited useful life, the duration of which can be ascertained with reasonable accuracy. *See generally Houston Chronicle*, 481 F.2d at 1248-50.[12] As applied, this test was consistently construed to allow the depreciation of *any* intangible asset that was demonstrated to have a wasting life with ascertainable value.

This case squarely presents a split in the circuits, for the Third Circuit has now rejected this approach. Instead, the Third Circuit has held that certain classes of intangible assets are nondepreciable as a matter of law, *notwith-*

[11] *See, e.g., Patterson v. Commissioner*, 810 F.2d 562, 569 (6th Cir. 1987) (goodwill "does not waste"); *Houston Chronicle*, 481 F.2d at 1248, (goodwill is "an ongoing asset that fluctuates but does not necessarily diminish"); *Colorado National Bankshares, Inc. v. Commissioner*, 60 T.C.M. (CCH) 771, 789 (1990) ("Goodwill, by definition, has an indefinite life . . . ."); *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223, 233 (1975), *acq.*, 65 T.C. 1153 (1976) (goodwill "may be expected to continue indefinitely").

[12] Indeed, in this very case, the government stipulated that this factual test was the proper method to determine whether an intangible asset is subject to a depreciation allowance. It was only *after* the district court made factual findings in favor of the petitioner that the government sought to argue that the issue of depreciability was a question of law.

standing proof and a determination by the factfinder that the particular asset at issue meets the requirements for depreciability under the *Houston Chronicle* test. Review by this Court is necessary to resolve this conflict among the circuits.

Seizing upon the oft-quoted but highly amorphous notion that goodwill is "the expectancy that old customers will resort to the old place," the Third Circuit made the sweeping conclusion that certain customer-based intangible assets transferred as part of a going concern are "inherently" goodwill because they contribute to continued patronage. Thus, despite the district court's finding that the value assigned to the particular customer-based assets depreciated in this case *was* separate and distinct from the newspapers' $23 million goodwill value (which was tied to, *inter alia*, *non*-subscription customers and advertisers), the Third Circuit held that the assets were *per se* nondepreciable.

The Third Circuit's decision that certain customer-based intangible assets transferred as part of a going concern are nondepreciable as a matter of law is in direct conflict with decisions by the Seventh, Eighth, Ninth, Eleventh and Federal Circuits, as well as the full panel of the Tax Court.[13] These courts have all explicitly held that customer-based intangible assets transferred as part of a going concern are depreciable pursuant to Section 167(a) of the Internal Revenue Code if, as with all types of intangible assets, the taxpayer demonstrates that the asset has an ascertainable value and a limited useful life. The Third Circuit's decision cannot be reconciled with these decisions.

[13] *See Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446 (Ct. Cl. 1976); *Super Food Services, Inc. v. United States*, 416 F.2d 1236 (7th Cir. 1969); *Commissioner v. Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966); *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990); *see also IT&S of Iowa, Inc. v. Commissioner*, 97 T.C. ___, [Current Regular Dec.] Tax Ct. Rep. (CCH) No. 34 (Nov. 12, 1991); *Colorado National*, 60 T.C.M. (CCH) 771 (1990); *Los Angeles Cent. Animal Hosp., Inc. v. Commissioner*, 68 T.C. 269 (1977), *acq.* 1978-2 C.B.2, *acq.* 1978-1 C.B.2; *First Pennsylvania Banking & Trust Co. v. Commissioner*, 56 T.C. 677 (1971), *acq.* 1972-1 C.B. 2.

For example, in *Donrey*, a case the Third Circuit acknowledged was "undeniably similar" (App. at 18a), the taxpayer purchased an Indiana newspaper that had approximately 11,000 paid subscribers. From the $1.3 million purchase price, the taxpayer allocated about half—approximately $560,000—to the subscription structure and sought to depreciate that amount. The government argued, as it did here, that the paid subscriber relationships represented continued patronage and were thus goodwill; but the jury found that Donrey had proved limited useful lives for its subscriber structure and a value ($560,000) that was separate and distinct from goodwill ($122,000). *Donrey*, 809 F.2d at 535-36. The Eighth Circuit affirmed the depreciability of the subscribers, rejecting the government's contention that the subscription structure was part of nondepreciable goodwill as a matter of law. *Id.* at 536.

The Third Circuit has now adopted the very argument the *Donrey* court rejected.[14] Morning Ledger proved limited useful lives for its paid subscribers, and the district court found a value for the subscription structures ($67 million) that was separate from the value of goodwill and going concern ($23 million). (App. at 5a, 7a, 47a). Such

[14] The Third Circuit did so in part on the mistaken belief that "[i]t would appear that *Houston Chronicle* and *Donrey* are directly in conflict." (App. at 19a). There is no such conflict. The district court judgment in *Donrey* was entered on the basis of jury interrogatories that tracked the *Houston Chronicle* standard, and the Eighth Circuit expressly cited *Houston Chronicle* with approval when it affirmed that judgment. *See Donrey*, 809 F.2d at 536-37. No other court has suggested these two decisions conflict in any way. To the contrary, the Tax Court recently cited both cases as standing for the same proposition. *IT&S of Iowa*, 97 T.C. ___, [Current Regular Dec.] Tax Ct. Rep. (CCH) at 4555-56.

proof of a limited life and a separate value rendered the subscriber-based asset depreciable in *Donrey*, *see* 809 F.2d at 536, but the Third Circuit nevertheless held that newspaper paid subscribers (and other similar intangible assets) were nondepreciable goodwill.

Similarly, the Third Circuit "respectfully disagree[d]" with the Eleventh Circuit's affirmance of the full Tax Court's decision in *Citizens & Southern*. (App. at 22a n.7a). In *Citizens & Southern*, the taxpayer acquired nine banks, allocating $10.4 million of the total purchase price to goodwill and $41.7 million to customer-based intangible assets denominated "deposit base." These "core deposits" were customer relationships indistinguishable from newspaper paid subscriber relationships. They were comprised of and valued on the future income stream (patronage) resulting from certain terminable-at-will checking and savings accounts existing at the time of acquisition. The IRS disallowed depreciation of the core deposits on "the assumption that terminable-at-will relationships represent goodwill." *Citizens & Southern*, 91 T.C. at 483. Yet, after an exhaustive review of the authorities, the full Tax Court rejected the government's argument. *Id.* at 483-90. The Eleventh Circuit affirmed the holding that the core deposit accounts were a depreciable intangible asset based on the Tax Court's opinion, *see* 919 F.2d at 1492, a result that cannot be squared with the result below.[15]

[15] The Third Circuit also admitted the "analytic force" of *Colorado National*, another Tax Court decision holding that core deposits could be depreciated, but chose not to follow it. (App. at 28a). In *Colorado National*, a taxpayer that acquired seven banks for a total purchase price of $88.2 million allocated $41.4 million to core deposits and $5.7 million to goodwill. 60 T.C.M. (CCH) at 776-77. The Tax Court held that terminable-at-will core deposits could be depreciated, because this customer-based intangible asset, while "closely interrelated to goodwill, . . . is nevertheless a separate and distinct asset," and it explicitly rejected the government's invitation to "inquire into the intrinsic nature of the asset measured and determine whether it is, in essence, goodwill." 60 T.C.M. (CCH) at 789-90. The Third Circuit recognized that *Colorado National* held "that any intangible asset possessing a determinable life and an ascertainable value is, by definition, not goodwill." (App. at 22a). Yet the Third Circuit then held exactly the opposite, with its assertion that "some" wasting intangible assets "are nonetheless goodwill." (App. at 29a).

Most recently, in *IT&S of Iowa*, a decision handed down subsequent to the Third Circuit's opinion, the government again asserted that the net income stream attributable to terminable-at-will core deposit accounts was future patronage/goodwill, representing no more than "inertia" where customers "[left] funds on deposit for an ascertainable length of time." 97 T.C. ___, [Current Regular Dec.] Tax Ct. Rep. (CCH) at 4556. The Tax Court reaffirmed *Citizens & Southern* and rejected this argument, holding that even though "a deposit account has no fixed termination date and is terminable at will," a taxpayer could prove the core deposits were an intangible asset separate and distinct from goodwill. *Id.* The ruling below is exactly the opposite.

For purposes of determining whether a customer-based asset is depreciable, the Third Circuit drew a decisionally-decisive distinction between fixed-term and terminable-at-will customer relationships. No other court has adopted this arbitrary distinction. Indeed, other courts have rejected it, creating a clear conflict. In *Super Food Services*, the taxpayer acquired a number of franchise contracts that were terminable-at-will on 30 days notice. However, the taxpayer offered proof that these terminable-at-will relationships had an average life of seven years. Rejecting the government's attempt to draw a distinction based on the form, rather than the substance, of the relationship, the Seventh Circuit held "it is immaterial that the contracts may have no fixed termination date" and "it also is immaterial whether these [at-will] contracts were acquired separately or as part of a going business." 416 F.2d at 1240. *See also Citizens & Southern*, 91 T.C. at 486 ("The fact that a deposit account has no fixed termination date and is terminable at will does not as a matter of law prevent [the taxpayer] from showing that [the asset] has an ascertainable cost basis separate and distinct from goodwill and that it has a reasonably ascertainable useful

life."); *accord IT&S of Iowa*, 97 T.C. ___, [Current Regular Dec.] Tax Ct. Rep. (CCH) at 4556 (even though "a deposit account has no fixed termination date and is terminable at will," a taxpayer can prove that the intangible asset is separate and distinct from goodwill).

The district court in this case had the proper analysis. Unlike the court of appeals, it recognized that the proper distinction was not one of form—between fixed-term and terminable-at-will relationships—but rather one of substance—between those relationships that are immeasurable and indefinite (goodwill) and those that have *determinable* lives and values:

> [O]ne must distinguish between a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity and future purchases cannot be predicted, against subscribers who can be predicted to purchase the same item, for the same price on a daily basis. . . . [T]he income derived from such paying subscribers will recur, which, in turn, permits the ascertainment of value separate and apart from goodwill.

(App. at 33a.)

In essence, the Third Circuit has transformed the vague *concept* of "goodwill" into the *test* for determining whether intangible assets are depreciable under Section 167(a) of the Internal Revenue Code. Contrary to the Third Circuit's decision, the oft-quoted description of goodwill—"old customers will resort to the old place"—was never intended, and has never before been invoked, as a dispositive litmus test that bars the depreciation of truly wasting intangible assets. To the contrary, in recognition that intangible assets may contribute to continued patronage yet still have "value separate and distinct from goodwill," courts have uniformly allowed depreciation deductions under Section 167(a) for a host of intangible assets that contribute to

continued patronage, including customer-based intangible assets (without fixed-term contracts) transferred as part of a going concern.[16]

In effect, the Third Circuit has significantly modified the widely-accepted *Houston Chronicle* test to require a three-part showing that the asset (i) has a limited useful life; (ii) has an ascertainable value; *and* (iii) has *no* indicia of goodwill whatsoever. In contrast, as applied by other courts, the *Houston Chronicle* test only requires proof that the asset is wasting (*i.e.*, requirement (i)) and that the ascertainable *value* for which a depreciation deduction is sought is separate and distinct from goodwill. In short, there simply is "no authority for the proposition that assets, intangible or tangible, are not separate and distinct from goodwill unless no part of their value is related to continued patronage of customers of an ongoing business." *Citizens & Southern*, 91 T.C. at 515 (Cohen, J., concurring); *accord Seaboard Finance*, 367 F.2d at 651.

As a result of the Third Circuit's decision, a host of intangible assets, long-recognized to be depreciable under Section 167(a) of the Internal Revenue Code because of their wasting nature, are now at risk of being labelled *per se* nondepreciable goodwill merely because they contribute to continued patronage. For example, if followed consistently, the Third Circuit's litmus test approach to goodwill would render a patent—explicitly recognized under Treasury Regulation 1.167(a)-3 as a depreciable intangible asset because of its limited useful life—nondepreciable "good-

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[16] Moreover, many courts that found customer-based intangible assets depreciable also recognized that goodwill is the concept that "old customers will resort to the old place" or is related to "continued patronage." *See, e.g., Richard S. Miller & Sons*, 537 F.2d at 450; *Seaboard Finance*, 367 F.2d at 649; *Citizens & Southern*, 91 T.C. at 480; *Colorado National*, 60 T.C.M. (CCH) at 787; *Los Angeles Cent. Animal Hosp.*, 68 T.C. at 273. Thus, the Third Circuit's assertion that courts which found customer-based intangible assets depreciable had applied the wrong "definition" of goodwill (App. at 23a) was plainly wrong.

will" if it contributes in any way to "the expectancy that old customers will resort to the old place." *Cf. Richard S. Miller & Sons*, 537 F.2d at 450. Similarly, fixed-term customer contracts undeniably contribute to future patronage, yet the Third Circuit conceded that such assets are depreciable pursuant to Section 167(a). (App. at 11a-12a).

The Third Circuit erroneously held that certain customer-based intangible assets transferred as part of a going concern are *per se* nondepreciable goodwill, and thus did not have to decide what valuation method was appropriate in this case. Nevertheless, it curiously went on to suggest that, had the taxpayer in this case valued the intangible assets pursuant to the cost method (*i.e.*, the cost of generating subscribers), rather than the income method (*i.e.*, the stream of income to be generated by the subscribers over their remaining useful lives), the assets would have been transformed from nondepreciable goodwill into depreciable intangible assets. The Third Circuit's apparent insistence on the use of the cost method conflicts with the decisions of every other court to consider the issue of depreciability under I.R.C. § 167(a).

Where taxpayers have sought to establish the value of a wasting intangible asset pursuant to the income method, courts have consistently allowed such valuations.[17] Indeed, intangible assets are *normally* valued pursuant to the income method under the tax laws, for this is the method a willing buyer and willing seller would ordinarily apply in determining the asset's sales price. (App. at 43a-44a); *see Colorado National*, 60 T.C.M. (CCH) at 792. *See generally United States* v. *Ludey*, 274 U.S. 295, 301 (1927); *supra* p. 7 n.7. Petitioner has been unable to find any decision, other than the Third Circuit's decision in this

[17] *See Citizens & Southern*, 91 T.C. at 505-06; *Colorado National*, 60 T.C.M. (CCH) at 792-94; *First Pennsylvania*, 56 T.C. at 692-97; *see also* App. at 18a (noting use of income method in *Donrey*).

case, that suggests that an intangible asset cannot be depreciated (*i.e.*, it is not a wasting asset) if valued pursuant to the income method.

II.

CERTIORARI SHOULD BE GRANTED TO RESOLVE A RECURRING DISPUTE OF ENORMOUS CONSEQUENCE CONCERNING THE ADMINISTRATION OF THE INCOME TAX LAWS.

The decision below has ramifications far beyond the instant case. The decade of the 1980s saw more than 31,000 reported business merger, acquisition, and divestiture transactions, with an aggregate value of more than $1.3 trillion. Martin Sikora, *The M&A Bonanza of the '80s . . . And Its Legacy*, Mergers & Acquisitions, Mar.-Apr. 1990, at 90.

In August 1991, the GAO prepared and issued a report to the Joint Congressional Committee on Taxation analyzing how the purchase price for acquired businesses was allocated among intangible assets. The GAO examined tax data the IRS had gathered in 1989 (generally covering tax years 1979 to 1987) from the IRS's unresolved, or open, purchased intangible asset cases. *GAO Report* at 13. It is important to note that the data the GAO examined reflects only a small portion of the purchased intangible asset universe: the data did not include unaudited tax returns, cases that had been closed, and post-1987 matters. *Id.*

Based on this data, the GAO estimated that from 1979 to 1987, taxpayers in nine major industry groups had claimed deductions for 175 types of purchased intangible assets, identified as distinct from goodwill, and valued at $23.5 billion. *GAO Report* at 3. By far the "largest category of intangibles" was the "customer- or market-based assets," assets that "related to the customer structure or market factors of a business." *Id.* at 22. Among the examples, the GAO listed core deposits, customer relations,

customer structure, and subscription lists. *See id.* at 40-42. Taxpayers in seven of the nine major industry groups had allocated $10.5 billion to these customer/market-based intangible assets, nearly three times the amount allocated to the next largest intangible category. *Id.* at 22. None of these assets were embodied in fixed-term contracts; the GAO separately reported what it called "contract-based intangible assets." *Id.* at 22.

As of 1989, the IRS identified 776 open audit matters involving these customer/market-based intangibles in its examination, appeals, and litigation units. *Id.* at 4, 22. The IRS had proposed tax adjustments of over $4.1 billion in these 776 cases, more than half of the total adjustments for *all* intangibles. *Id.* Indeed, as a general matter, the GAO found that "[i]n 70 percent of the cases in which taxpayers claimed that intangible assets had a determinable useful life, IRS claimed that the assets were in fact goodwill and not amortizable." *Id.* at 4.

Because of the overwhelming recurrence of the disputed issue here and its enormous consequence in the administration of the nation's revenue laws, review by this Court is imperative. *See, e.g., Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 427 (1955).

III.

CERTIORARI SHOULD BE GRANTED BECAUSE THE THIRD CIRCUIT'S DECISION IS A SERIOUS DEPARTURE FROM THE GOVERNING STATUTE.

The Third Circuit's decision that certain customer-based assets are *per se* nondepreciable goodwill is flatly inconsistent with Section 167(a) of the Internal Revenue Code. Fundamentally, income tax is a tax on *net* income. To enable a business to offset annual expenses against revenues, Congress has specifically authorized depreciation deductions for wasting assets. *See Gambrinus Brewery Co.*, 282 U.S. at 643. For if a taxpayer cannot depreciate the

value of a wasting asset but is still taxed on the income the asset produces, the taxpayer would be taxed on more than the *net* income the taxpayer has actually earned. Section 167(a) of the Code, which embodies this principle, thus provides that a depreciation deduction "shall be allowed" for the "exhaustion" of property used in a business or to produce income.

To effect the statute's purpose, courts have always treated intangible assets with identifiable limited useful lives like tangible property for purposes of depreciation. *See Richard S. Miller & Sons*, 537 F.2d at 450. Thus, customer-based intangible assets with proven limited lives have consistently been found to be depreciable. *See, e.g., Super Food Services*, 416 F.2d at 1240; *Citizens & Southern*, 91 T.C. at 480-89 (collecting cases). Morning Ledger's paid subscriber relationships were intangible assets (property) that, under the district court's findings, were being exhausted (*i.e.*, they had wasting lives). A depreciation deduction would have been available, but for the Third Circuit's unprecedented inclusion of assets with definite and wasting lives in "goodwill."

There is simply no authority to suggest that Congress intended to limit depreciation deductions to assets that have no connection whatsoever to future patronage. Rather, the deductions are intended to match actual expense against income. To achieve this end, a depreciation deduction must apply to all wasting assets. The *Houston Chronicle* court put the point well. Referring to the Eighth Circuit's decision in *Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128 (8th Cir. 1960), the court stated:

> As the concurring opinion of then-Circuit Judge Blackmun makes clear, if the asset is shown to be a wasting one used in the taxpayer's trade or business, a reasonable deduction *must* be allowed.

Houston Chronicle, 481 F.2d at 1251 (emphasis added).[18]

[18] The majority view—that customer-based intangible assets are de-

Accordingly, the applicable Treasury regulation states that an intangible asset known to be of use "for only a limited period" may be "the subject of a depreciation allowance." Treas. Reg. § 1. 167(a)-3. Limited life is the crucial concept. The regulation continues that depreciation is *not* allowed for "[a]n intangible asset, the useful life of which is not limited . . . ." *Id.*

The reason goodwill is not depreciable under the Treasury regulation is precisely because goodwill is *not* a wasting asset—it does *not* have a definite life. The Third Circuit's ruling discards this universally-accepted, fundamental characteristic of goodwill—a characteristic that served not only to define but, just as importantly, to limit the parameters of "goodwill." The focus on a determinable, limited life in the Internal Revenue Code and Treasury regulation enables questions of depreciability to be resolved without having to decide what "goodwill" is; it is enough if one knows what "goodwill" is not.

Thus, until the ruling below, courts consistently held that goodwill had an indefinite life. *See, e.g., Patterson*, 810 F.2d at 569 (goodwill "does not waste"); *Richard S. Miller & Sons*, 537 F.2d at 454 ("An intangible asset is separate and distinct from goodwill when its useful life can be shown with reasonable accuracy to be of limited duration."); *Houston Chronicle*, 481 F.2d at 1248 (goodwill is "an ongoing asset that fluctuates but does not necessarily diminish"); *Computing & Software*, 64 T.C. at 233 (goodwill "may be expected to continue indefinitely"); *Colorado National*, 60 T.C.M. (CCH) at 789 ("Goodwill, by

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preciable—is also consistent with generally accepted accounting principles, principles adopted by the Securities and Exchange Commission and other recognized practices in the business community relating to the identification of goodwill. *See, e.g., Colorado National*, 60 T.C.M. (CCH) at 788-89; *cf. Northern Natural Gas Co.*, 277 F.2d at 140 (Blackmun, J., concurring) (depreciation deduction for truly wasting asset "seems to me to coincide with good business practice and good accounting.")

definition, has an indefinite life . . . ."); *IT&S of Iowa*, 97 T.C. ___, [Current Regular Dec.] Tax Ct. Rep. (CCH) at 4556 ("mere inertia, which lasts for only a limited time, should not be equated with the continued patronage of a business over an indefinite period.").

The Third Circuit has now departed from this authority with its holding that "some intangible assets" are goodwill "notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values." (App. at 29a). Until now, because a necessary characteristic of goodwill was an indefinite life, it was logically inescapable that the value of a wasting asset was not part of goodwill. Every court that had considered that issue had so held. *See Super Food Services*, 416 F.2d at 1240 (summary judgment for government improper where terminable-at-will franchise contracts had limited useful lives); *First Pennsylvania*, 56 T.C. at 697-98 n.12, (terminable-at-will customer contracts having a "definite life expectancy" may be valued separately from goodwill); *see also Richard S. Miller & Sons*, 537 F.2d at 452; *Seaboard Finance*, 367 F.2d at 653; *Colorado National*, 60 T.C.M. (CCH) at 790. The ruling below illogically results in assets with proven definite lives being treated as if they had indefinite lives. The Third Circuit's approach abandons a crucial and easily administered limitation on "goodwill" for a standardless inquiry into the "essence" of goodwill. A host of limited-life intangible assets are now at risk of being brought within some "penumbra" of "goodwill," and rendered nondepreciable, if they have *some* connection with patronage.

What the Third Circuit ignored is that implicit in the notion of goodwill is uncertainty. However, as the district court correctly found, there is no uncertainty associated with the paid subscribers at issue in this case. Their value "does not depend on some vague hope" that they will continue to purchase newspapers. *See Citizens & Southern*, 91 T.C. at 499; *Colorado National*, 60 T.C.M. (CCH) at

789. The value of the paid subscriber relationships here (like the customer relationships in *Citizens & Southern* and *Colorado National*) lies in the ascertainable probability, proved at trial and found by the district court, that these paid subscriber relationships will continue for predictable periods. The papers' goodwill, in contrast, is tied to *other* customers, such as advertisers or people who buy their papers at newsstands, who must make affirmative decisions to continue patronizing the newspaper. *Their* value and life are uncertain and, tellingly, no depreciation deduction was sought by Morning Ledger for those customer relationships.

CONCLUSION

The decision of the Third Circuit creates a square and acknowledged conflict in the circuits, drastically expands the concept of nondepreciable "goodwill," adopts a rule of law that is without basis in statutory or regulatory text, and affects billions of tax dollars. The decision creates inconsistency and uncertainty in the application of federal tax law to innumerable business transactions. Accordingly, this case presents a nationally-significant question of federal law that merits this Court's attention.

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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January 13, 1992

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

NO. 90-5637

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY,
Appellee

v.

THE UNITED STATES OF AMERICA,
Appellant

On Appeal From The United States District Court
For The District of New Jersey
(D.C. Civ. No. 88-04836)

Argued: January 23, 1991

Decided: September 12, 1991

Before: BECKER and HUTCHINSON,
***Circuit Judges,* and SMITH,**
District Judge.*

As Amended on Denial of Rehearing October 15, 1991

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* Honorable D. Brooks Smith, United States District Judge for the Western District of Pennsylvania, sitting by designation.

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OPINION OF THE COURT

BECKER, Circuit Judge.

This appeal by the United States from an adverse judgment of the district court in a tax refund case raises important questions concerning a taxpayer's ability to depreciate acquired intangible assets. Taxpayer/appellee Newark Morning Ledger Co. ("Morning Ledger") acquired a corporation, which itself had previously acquired the assets of eight Michigan newspapers by means of an I.R.C. §§ 332, 334(b)(2) liquidation, and which had attempted to depreciate some $67 million of the purchase price as allocated to a category denominated "paid subscribers." This amount reflected an estimate by financial and statistical experts of the present value of the future profits to be derived from the 460,000 at-will subscribers acquired in the liquidation. The Internal Revenue Service ("the Service") disallowed the depreciation deductions on the ground that Morning Ledger's predecessor could not, by sophisticated and accurate expert analysis, convert into a depreciable asset what was quintessentially goodwill—i.e., the value of the expectation of continued patronage. The tax was paid, the refund suit ensued, and, after a bench trial, the district court entered judgment for Morning Ledger. For the reasons that follow, we will reverse.

I. FACTS AND PROCEDURAL HISTORY

Over a period of several months in 1976, the Herald Company ("Herald") purchased, through private sales and a public tender offer, all the outstanding stock of Booth Newspapers, Inc. ("Booth"), a Michigan corporation which published daily and Sunday newspapers in eight Michigan communities with a total at-will subscription of approximately 460,000.[1] In 1977, Herald liquidated the Booth

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[1] The eight Michigan newspapers published by Booth were the *Ann Arbor News; Bay City Times; Flint Journal; Grand Rapids Press;*

stock, received all the latter's assets, and continued publishing the eight newspapers under the same names. In 1987, Herald was merged into appellee Morning Ledger, a New Jersey corporation, effectively making the operations of Herald and Booth unincorporated divisions of Morning Ledger.

Herald's 1977 liquidation of the stock of Booth was carried out pursuant to sections 332 and 334(b)(2) of the Internal Revenue Code. These sections required Herald's $328,173,154 adjusted tax basis in Booth's stock to be allocated among the various depreciable and non-depreciable assets of Booth distributed to Herald in the liquidation in accordance with the respective fair market values of the assets. Herald allocated $234,063,002 of this amount to various financial assets (cash, securities, including the stock of *Parade*, and accounts and notes receivable); and to tangible assets (land, improvements to land, buildings, production and office equipment, furniture, fixtures, vehicles, computer hardware and software). Herald allocated the remaining $94,110,152 to three intangible assets—$26,337,152 to goodwill and going-concern value combined, and $67,773,000 to a category Herald denominated as "paid subscribers." The amount earmarked as paid subscribers represented Morning Ledger's estimate of the future profits to be derived from the 460,000 at-will subscribers acquired from Booth, all or most of whom were expected to continue to subscribe to the various newspapers after the change in control.

Beginning with its 1977 tax return, Herald claimed depreciation deductions for various assets acquired in the liquidation of Booth. Consistent with applicable regulations, discussed *infra*, Herald did not attempt to claim

Jackson Citizen Patriot; Kalamazoo Gazette; Muskegon Chronicle; and the *Saginaw News*. In addition, Booth owned the stock, valued at roughly $100 million, of the company that published the nationally-distributed Sunday newspaper magazine supplement *Parade*.

depreciation deductions for goodwill or going concern value. On its 1977 through 1980 returns, however, Herald claimed as depreciation deductions a portion of the $67,773,000 amount allocated to paid subscribers. The Service disallowed these deductions on the ground that the amount allocated to paid subscribers should have been included in the amount allocated to non-depreciable goodwill. The Service therefore determined that Herald owed additional taxes and interest for each of the applicable years, which Herald paid in full.

Morning Ledger, as successor to Herald, filed a timely claim for refund with the Service in 1988. After the Service failed to act upon the claim within the six month period prescribed by I.R.C. § 6532(a), Morning Ledger filed the instant action, in the district court for the District of New Jersey, to recover federal income taxes and interest erroneously assessed and collected.

The district court conducted a bench trial at which Morning Ledger argued that, under the relevant regulations and case law, discussed *infra*, in order to depreciate the paid subscribers as an intangible asset, it need only prove that the 460,000 at-will subscriber relationships acquired from Booth: (1) had limited useful lives that could be estimated with reasonable accuracy; and (2) also had ascertainable values separate and distinct from goodwill. Under Morning Ledger's interpretation of these requirements, depreciation deductions were available provided it could satisfy the essentially statistical and factual burden of demonstrating that the subscriber relationships had limited useful lives and that they had ascertainable values.

To this end, Morning Ledger presented the testimony of financial and statistical experts who explained that, based on historical and demographic data, and taking due consideration of actuarial factors such as death, relocation, changing life-styles and tastes, and competition from other media sources, they had arrived at reasonable estimates

of how long the average at-will subscriber existing in 1977 would continue to subscribe to the various newspapers. These estimates ranged from a low of 14.7 years for subscribers to the *Ann Arbor News* to a high of 23.4 years for subscribers to the *Bay City Times*.

These experts further testified that, from among the market, cost, and income approaches to valuing the existing subscriber relationships in 1977, the income approach provided the only appropriate methodology. Employing this approach, the experts testified that they first calculated the present value of the gross revenue stream that would be generated by these subscribers over their estimated useful lives. From this amount, they subtracted the projected costs of collecting that subscription revenue. The experts opined that the resultant net revenue stream, estimated by one expert as $67,773,000 and by another as $60,470,000, represented a reasonable estimate of the value of the intangible asset designated as paid subscribers.

For the most part, the Service did not contest Morning Ledger's expert evidence. Indeed, the Service stipulated to Morning Ledger's estimates of the useful lives of the subscription relationships. It did contest Morning Ledger's reliance on the *income* method of valuation, arguing that, assuming that the asset was depreciable at all, the *cost* method was the only appropriate method, and that the cost of generating 460,000 subscribers through a subscription drive was on the order of only $3 million. The Service refused, however, despite the district court's entreaties, to present expert evidence to refute Morning Ledger's estimates of the value of the subscriber relationships under the income method.[2]

[2] As noted, in valuing the subscriber relationships under the income method, Morning Ledger's experts reduced the present value of the anticipated gross income stream only by the projected costs of collecting subscription fees. The district court was concerned that Morning Ledger had overstated the value of the subscriber relationships by failing to reduce the projected gross income stream from the subscribers by a pro-rata portion of the newspapers' editorial and production costs and overhead. Morning Ledger argued, in justifying its valuations, that the eight newspapers derived upwards of 80 percent of their total revenues from advertising fees. Thus, Morning Ledger argued, all the costs of putting together and printing the newspapers were expended to generate this advertising revenue. The roughly 20 percent of total revenues generated by subscribers was, under Morning Ledger's theory, essentially "gravy" and thus should be viewed as being generated without additional cost other than collection costs. The district court was suspicious, in our view justifiably so, of this reasoning. But the government refused to provide contradictory expert valuation under the income method. Eventually, Morning Ledger's expert who had originally calculated the value of the subscription relationships at $67,773,000 testified that even assuming a pro-rata allocation of costs and overhead, their value would be reduced only to $61,500,000. *See* 734 F. Supp. 176, 182.

The crux of the Service's case, rather, was that Morning Ledger had misinterpreted the applicable law and that all its sophisticated financial and statistical evidence was therefore irrelevant to the fundamental legal hurdle which it could not overcome. That hurdle, in the Service's submission, is that governing law requires a taxpayer to do more than demonstrate a reasonable estimate of useful life and an ascertainable value in order to depreciate a purchased intangible asset; in addition, the taxpayer is required to demonstrate that the asset *is not goodwill*. In the Service's view, the future stream of revenues expected to be generated by the existing 460,000 at-will subscribers is the very essence of the goodwill value of the newspapers and, as such, is not depreciable.

The district court rejected the Service's argument, holding, in effect, that any asset for which a useful life could be demonstrated and a value ascertained was, by definition, not goodwill. Having reached this conclusion, and having no expert evidence before it but that of Morning Ledger, the court held that Morning Ledger was entitled to depreciate the paid subscribers account over its esti-

mated useful lifetime based on a total value of $67,773,000, which amount the court allocated to the various daily and Sunday newspapers. The court ordered the parties to calculate, and the government to repay, all taxes erroneously paid by Morning Ledger and applicable interest thereon.

The Service timely appealed from the final judgment of the district court. We thus have jurisdiction pursuant to 28 U.S.C. § 1291. Determining whether a taxpayer has satisfied the requirements for depreciating an intangible asset is generally a factual question. *See Manhattan Co. of Virginia, Inc. v. Commissioner*, 50 T.C. 78, 92-93 (1968). Hence, we review the district court's factual findings for clear error. Of course, to the extent that the district court misinterpreted or misconstrued the governing law, our review is plenary.

II. DISCUSSION

A. *The Regulations, The Nature of Goodwill, and the Contentions of the Parties*

I.R.C. § 167(a) allows as a depreciation deduction a reasonable allowance for exhaustion, wear and tear, and obsolescence of property, both tangible and *intangible*, used in a trade or business. Treasury Regulation 1.167(a)-3 elaborates on the depreciation of intangibles as follows:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. *No deduction for depreciation is allowable with respect to goodwill. . . .*

26 C.F.R.§ 1.167(a)-3 (emphasis added).

Case law interpreting this regulation has held consistently that, in order to qualify for depreciation of an intangible asset, a taxpayer must establish that the intangible asset (1) has an ascertainable value *separate and distinct from goodwill*, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy. *See, e.g., Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1250 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129, 94 S.Ct. 867, 38 L. Ed. 2d 754 (1974).[3]

As we have noted, the Service essentially concedes that Morning Ledger has demonstrated that the paid subscribers have an ascertainable value and limited useful lives, and that it has presented a reasonably accurate estimate of these useful lives. In Morning Ledger's view, detailed *infra*, this concession should end the case. The Service argues, however, that Morning Ledger has ignored, and convinced the district court to ignore, the additional requirement that the value of the paid subscribers be shown to be *"separate and distinct from goodwill,"* consistent with the explicit statement in the regulations that *"[n]o deduction for depreciation is allowable with respect to goodwill."* This prohibition against depreciating goodwill, the Service notes, is nearly as old as the income tax itself, its origin being traceable to a 1927 amendment to the predecessor regulation of § 1.167(a)-3.[4]

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[3] The Service itself adopted the *Houston Chronicle* test shortly after its publication. *See* Rev. Rul. 74-456, 1974-2 C.B. 65.

[4] As amended, the predecessor to § 1.167(a)-3 read:

> Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights. Intangibles, the use of which in the trade or business is not so limited, will not

The Service further argues that, once we recognize that the district court ignored this requirement, the error of permitting Morning Ledger to depreciate the net income stream to be generated by the 460,000 at-will subscribers becomes evident. Morning Ledger cannot demonstrate that this income stream is separate and distinct from goodwill, the Service contends, because, in fact, it is the essence of goodwill. Although goodwill is not defined in the regulations,[5] it has been repeatedly characterized in the case law

usually be a proper subject of such an allowance. If, however, an intangible asset acquired through a capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. *No deduction for depreciation, including obsolescence, is allowable in respect of goodwill.*

T.D. 4055, VI-2 CB 63; Regulations 69, Art. 163 (Revenue Act of 1928) (emphasis added). This amendment followed the decision in *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763, 47 S. Ct. 476, 71 L. Ed. 879 (1927), which denied a depreciation deduction for lost goodwill to a distillery forced out of business by Prohibition.

[5] As we have noted, the governing regulations have prohibited the depreciation of goodwill for over sixty years. *See supra* note 3. During that time, the meaning of the term "goodwill" has been litigated repeatedly, and often with high stakes, as taxpayers attempt to minimize the tax burden associated with purchased intangible assets by minimizing the amount of the purchase price allocated to nondepreciable goodwill. Despite the recurrence of the issue, neither Congress, the Treasury, nor the Service has seen fit to promulgate a uniform or coherent definition of the term. Rather, the Service apparently has been content to permit the courts to wrestle, case-by-case, with the contours of this elusive concept, with the result that it wins most cases because the taxpayer cannot sustain the onerous burden of establishing value and determinable life.

We note that the absence of a clear definition of this critical term, and the resulting confusion in applying the regulations, have generated much criticism among the commentators. *See* Mundstock, *Taxation of Business Intangible Capital*, 135 U. Pa. L. Rev. 1179, 1206-07 (1987);

as "the expectancy that old customers will resort to the old place," *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963), and as "the expectancy of continued patronage, for whatever reason," *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962). Because the projected stream of income to be generated by the 460,000 at-will subscribers is simply a quantification of Morning Ledger's expectation that these subscribers will continue their patronage, the Service submits that the amount is a portion of the total non-depreciable goodwill purchased from Booth.

We note in this regard, and the Service does not dispute, that the value of the paid subscribers would not constitute goodwill if Morning Ledger's "expectation of continued patronage" were contractually-based. *See Commissioner v. Seaboard Finance Co.*, 367 F.2d 646, 649 (9th Cir. 1966) ("[G]oodwill [is] 'the probability that old customers will resort to the old place' without contractual compulsion.") (citation omitted). Thus, if the subscribers were contractually obligated to continue subscribing for some period of time, Morning Ledger clearly would be permitted to depreciate the value of those contracts over

Dubin, *Allocation of Costs to, and Amortization of, Intangibles in Business Acquisitions*, 57 Taxes 930, 933 (1979); Grigsby & Cotter, *Amortization of Certain Intangibles*, 30 U.S.C. Tax Inst. 543, 545 (1978); Gregorcich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 Tax Law. 251, 258-59 (1975); Frank, *Goodwill is Not Immortal: A Proposal to Deduct The Exhaustion of Purchased Goodwill*, 23 J. Taxation 380, 380-81 (1965); Note, *An Inquiry Into the Nature of Goodwill*, 53 Colum. L. Rev. 660, 685-86 (1953). For the views of other commentators who have examined this troublesome corner of the tax law, *see* B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 23.2.6, at 23-35 (2d ed. 1989); Comment, *Depreciability of Going Concern Value*, 122 U. Pa. L. Rev. 484 (1973); Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 Harv. L. Rev. 859 (1968); Schenk, *Depreciation of Intangible Assets: The Uncertainty of Death and Taxes*, 13 Wayne L. Rev. 501 (1967).

that time period. In such an event, continued patronage would not be a mere "expectation," but a contractual right, and hence not goodwill. In the case at bar, however, all the subscribers are *terminable-at-will*. At the time of the acquisition of Booth, therefore, Herald merely expected continued patronage; it had no contractual right to demand it. Morning Ledger responds that it has not ignored the requirement that the paid subscribers be shown to have a value "separate and distinct from goodwill." Rather, Morning Ledger contends, the Service has invoked the wrong definition of "goodwill" and thus has misconstrued the requirements of § 1.167(a)-3. Morning Ledger argues that, properly defined, goodwill is no more than the residual value that remains after all assets with determinable useful lives and ascertainable values have been accounted for. Thus, by converse reasoning, anything possessing a determinable useful life and an ascertainable value is not goodwill.[6] Under Morning Ledger's definition of goodwill, in other words, the requirement that an intangible asset be shown to have a value "separate and distinct from goodwill" adds nothing to the undisputedly satisfied requirement that the taxpayer demonstrate that the asset has a limited useful life and provide a reasonably accurate estimate of that life.

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[6] Morning Ledger makes this argument most forcefully in the following passage in its brief:

> The government recognizes that a "basic premise of the Regulation [§ 1.167(a)-3]" is "that goodwill has an indeterminate useful life." Given this basic premise, an asset with a "determinate" useful life cannot be goodwill under the regulation. Nevertheless, the government attempts to define "goodwill" to include any intangible customer base asset acquired as part of a going concern, "even if it could be shown in a given case to have a finite duration." Not surprisingly, the government cites no authority for this "inference." To the contrary, . . . if an asset has a limited useful life, by definition it is no longer goodwill for purposes of depreciation.

Appellee's Brief at 32-33 (citations omitted).

Although the district court apparently sought to reconcile the competing definitions of goodwill, it is clear from the following passage that ultimately the court accepted the definition advanced by Morning Ledger over that pressed by the Service:

> [T]he court recognizes and accepts that goodwill is the expectancy that former customers will be retained—that there will be continued patronage. However, one must distinguish between a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity and future purchases cannot be predicted, against subscribers who can be predicted to purchase the same item, for the same price on a daily basis. Although newspaper subscribers are under no legal obligation to continue their subscriptions, expert opinion and the evidence presented coupled with common sense and experience leads inescapably to the conclusion that the income derived from such paying subscribers will recur, which, in turn, permits the ascertainment of value separate and apart from goodwill. The income derived from the subscribers permits the calculation of value over the useful lives of the subscriptions or subscribers, and renders the subscribers acquired subject to valuation as an asset separate and apart from goodwill.

Newark Morning Ledger Co. v. United States, 734 F. Supp. 176, 176-77 (D.N.J. 1990).

B. *The Newspaper Subscriber List Cases*

In furtherance of their respective arguments, the parties call our attention principally to two cases that have considered the depreciability of acquired subscriber lists in the context of a newspaper acquisition. Because these two cases present a useful vehicle for framing the instant dispute, we will consider each in some detail.

The Service places substantial emphasis on the Fifth Circuit's decision in *Houston Chronicle Publishing Co. v.*

United States, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129, 94 S.Ct. 867, 38 L. Ed. 2d 754 (1974), as an example of the correct application of § 1.167(a)-3 to determine the tax consequences of an acquisition such as the one before us. That case arose from a transaction in which the plaintiff, the publisher of the *Houston Chronicle*, paid $4.5 million for various assets, including a list of 89,000 subscribers, of its former competitor, the *Houston Press*, upon cessation of the latter's activities as a going concern. After the purchase, the *Chronicle* estimated that it would be able to use the list to contact and solicit new subscriptions from 35,600 former *Press* subscribers. Estimating further that previously it had spent roughly $2 to identify and solicit each new subscriber, the *Chronicle* assigned a value to the list of $71,200 and claimed depreciation deductions against this amount under § 167(a).

The Service disallowed the deduction on the ground that the customer list was nondepreciable under the so-called "mass asset rule," a now outdated, but then prevalent, doctrine which requires brief explanation. Until 1973, the Service successfully had persuaded the courts that documentary evidence of customer structure, such as a customer list, was generally sufficiently intertwined with goodwill, if not goodwill itself, so as to render depreciation inappropriate as a rule-of-thumb. There emerged, in support of this result, the mass asset or indivisible asset doctrine, a sort of legal fiction that customer lists, and other documentary evidence of customer structure, are presumed like goodwill to be self-regenerating and *per se* nondepreciable.[7]

[7] Perhaps the most comprehensive statement of the theory behind the mass asset doctrine is found in *Golden State Towel and Linen Service, Ltd. v. United States*, 373 F.2d 938, 179 Ct. Cl. 300 (1967). In that case, the Court of Claims invoked the doctrine in affirming the Service's denial of depreciation deductions claimed by a linen service corporation that had acquired all of the assets of two competitors, and then sought to capitalize the portion of the purchase price attributable to acquired customer lists. The court stated:

> [Plaintiff seeks] an implausible separation of customer lists from goodwill, one a mirror reflection of the other, for goodwill = expectancy of continued patronage = customer lists = goodwill. At least, if goodwill and customer lists are not mutually coextensive, the former includes the latter, and the lesser is inextricable from the greater. In the vernacular, goodwill is a customer list with trimmings. . . .
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> [A] purchased terminable-at-will type of customer list is an indivisible business property with an indefinite, nondepreciable life, indistinguishable from—and the principal element of—goodwill, whose ultimate value lies in the expectancy of continued patronage through public acceptance. It is subject to temporary attrition as well as expansion through departure of some customers, acquisition of others, and increase or decrease in the requirements of individual customers. A normal turnover of customers represents merely the ebb and flow of a continuing property status in this species, and does not within ordinary limits give rise to the right to deduct for tax purposes the loss of individual customers. The whole is equal to the sum of its fluctuating parts at any given time, but each individual part enjoys no separate capital standing independent of the whole, for its disappearance affects but does not interrupt or destroy the continued existence of the whole.

Id., 373 F.2d at 942-44. For examples of other applications of the mass asset doctrine, *see Thoms v. Commissioner*, 50 T.C. 247 (1968) (denying depreciation of list of insurance expirations purchased in conjunction with sale of insurance agency as going concern on ground that list was "inextricably linked with goodwill" of seller under mass asset doctrine); *Marsh & McLennan, Inc. v. Commissioner*, 420 F.2d 667 (3d Cir. 1969) (affirming Tax Court's denial of depreciation deductions for acquired insurance expirations under mass asset rule); *Skilken v. Commissioner*, 420 F.2d 266 (6th Cir. 1969) (affirming Tax Court's denial of depreciation for 922 acquired oral, terminable at-will location agreements for vending machines on ground that such agreements were comparable to customer lists and thus nondepreciable as inextricably intertwined with goodwill under mass asset doctrine).

The *Houston Chronicle* filed a refund suit, contesting the Service's determination in federal district court. A jury trial was held, the *Chronicle* prevailed, and the Service appealed. The Fifth Circuit affirmed. Specifically, after re-

viewing many of the prior cases and reaffirming the definition of goodwill as "the expectancy that the old customers will resort to the old place," and "the expectancy of continued patronage, for whatever reason," *see supra* at [11a], the court concluded, essentially rejecting the mass asset rule, that the government was incorrect in asserting that the "subscription lists [were] non-amortizable as a matter of law." *Id.* at 1248. In the passage that has become the standard for all subsequent related cases, the court went on to state:

> Without compiling the myriad cases that discuss the "mass asset" rule, we are satisfied that the rule does not establish a *per se* rule of non-amortizability in every case involving both goodwill and other intangible assets. In the light of § 167(a) of the Code and Regulation § 1.167(a)-3, we are convinced that the "mass asset" rule does not prevent taking an amortization deduction if the taxpayer properly carries his dual burden of proving that the intangible asset involved (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy.

Id. at 1249-50.

It is clear from this passage, the Service contends, that the two-pronged test articulated by *Houston Chronicle* was intended to inter the notion that some intangible assets, although not necessarily goodwill, were nonetheless so intertwined with goodwill as to be nondepreciable as a matter of law in all cases—i.e., the mass asset rule. The Service adds, however, that there is no indication in *Houston Chronicle* that the court intended to hold that goodwill itself was depreciable or to replace what it had confirmed to be the traditional definition of goodwill with the residual definition such as is urged by Morning Ledger in the instant dispute. Rather, the Service contends, the court

merely held that in those cases where a taxpayer could demonstrate, as a factual matter, that an intangible asset such as a subscriber list was "separate and distinct" from the legal concept of goodwill—i.e., the "expectancy that old customers will resort to the old place," it ought to be permitted to do so.

As a factual matter, the Service adds, the circumstances supporting the finding that the taxpayer in *Houston Chronicle* had demonstrated that the subscriber list was "separate and distinct" from goodwill are clearly distinguishable from the instant dispute. The *Houston Chronicle* did not purchase an ongoing business or even a tradename as did Morning Ledger, but rather the idle assets of the defunct *Houston Press*. Hence, there was no "expectancy that old customers would resort to the old place" because "the old place" no longer existed. The value of the customer list to the *Houston Chronicle* therefore lay solely in its potential use as a marketing tool to solicit *new* customers to a *new* business. As such, the asset was appropriately valued at the *cost* of generating a comparable list of potential subscribers, not, as Morning Ledger has attempted, as the entire net stream of *income* such subscribers would generate if obtained. In short, the Service argues that, unlike the present dispute, there was no goodwill transferred in the acquisition of the assets of the *Houston Press* and thus no risk that goodwill would be bound up and depreciated along with the subscriber list.

In sum, contends the Service, *Houston Chronicle* presented the paradigmatic circumstances under which a taxpayer could demonstrate that a subscriber list is "separate and distinct from goodwill." The Service argues that the instant dispute, by contrast, presents a clear case wherein it is virtually impossible for the taxpayer to disentangle the potentially depreciable value of the list from the value of the nondepreciable goodwill transferred. In any event, on the record as it stands, and particularly in light of Morning Ledger's insistence on employing the income

method of valuation, the Service argues that Morning Ledger clearly has not demonstrated that the $67,773,000 value it assigned to the list is "separate and distinct from goodwill."

Morning Ledger advances as its strongest authority the Eighth Circuit's decision in *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987). Although a much smaller transaction in absolute dollar terms than the acquisition of Booth by Morning Ledger, the case is undeniably similar to the instant dispute in terms of the material aspects of the transaction. Specifically, in *Donrey* the taxpayer purchased a small Indiana newspaper with roughly 11,000 at-will subscribers for $1,335,804 and as a going concern. The taxpayer assigned $559,406 to the newspaper's customer list/customer structure and attempted to depreciate that amount over 23 years. Although the case is not explicit on this point, it is reasonable to assume, given the amount allocated to the customer list relative to the total purchase price, that this amount was calculated under the income, rather than cost method, of valuation.

When the Service denied the depreciation deductions on the theory that the taxpayer was seeking to depreciate goodwill, the taxpayer sued for a refund in district court and demanded a jury trial. The case was submitted to the jury on special interrogatories tracking the standards of *Houston Chronicle*, and the taxpayer prevailed. A divided Eighth Circuit panel rejected the government's appeal.

The Eighth Circuit majority's reasoning is somewhat cursory, and is largely premised on the substantial deference due the jury's determination that the taxpayer had proved a value separate and distinct from goodwill. *Donrey*, 809 F.2d at 536-37. Morning Ledger argues convincingly, however, that the majority's reasoning implicitly adopted the residual definition of goodwill urged by Morning Ledger here. Indeed, this reading of the case is confirmed by Judge Bright's eloquent dissent, which takes the

majority to task for ignoring the traditional definition of goodwill, and in so doing, for concluding wrongly that the taxpayer had demonstrated that the value of the customer structure was "separate and distinct from goodwill." *Id.* at 537-39 (Bright, J., dissenting).

C. *The Case Law in Overview*

It would appear that *Houston Chronicle* and *Donrey* are directly in conflict. Before charting our own course, it therefore behooves us to look beyond the cases involving newspaper subscriber lists to the plethora of other cases that have considered the depreciability of customer or subscriber lists in other industries. This exercise, we believe, clearly indicates that the case law division is greatly overstated by Morning Ledger. Viewed in the context of the case law as a whole, there is undeniably some authority consistent with *Donrey* and supportive of the argument advanced by Morning Ledger. The overwhelming weight of the authority, however, lines up squarely behind the Service's reading of *Houston Chronicle*. Given the amount of ink that has been spilled over this subject already both in the literature, *see supra* [13a-15a], and in the case law, we will not survey the case law in detail. The following review of some of the better authorities should suffice.

Several cases support, to some degree or another, Morning Ledger's argument that any intangible asset which possesses a determinable useful life and which is capable of valuation is not goodwill. For example, a line of cases from the Court of Claims comes very close to adopting Morning Ledger's definition of goodwill. *See Meredith Broadcasting Co. v. United States*, 405 F.2d 1214, 1224-25, 186 Ct. Cl. 1 (1968); *KFOX, Inc. v. United States*, 510 F.2d 1365, 1376-77, 206 Ct. Cl. 143 (1975); *Richard S. Miller & Sons, Inc., v. United States*, 537 F.2d 446, 450-54, 210 Ct. Cl. 431 (1976). Perhaps the clearest statement of the Court of Claims' view is found in the following passage from *Richard S. Miller*:

The term "goodwill" has a varying content, depending on its usage. Goodwill sometimes is used to describe the aggregate of all of the intangibles of a business, including such items as patents, trademarks, leases, contracts, and franchises. Since a normal rate of return usually is calculated on tangible assets only, goodwill has been used as a synonym for the return on all the intangibles of a business. In a more restricted sense, goodwill is the expectancy that the old customers will resort to the old place. It is the sum total of all the imponderable qualities that attract customers and bring patronage to the business without contractual compulsion. Another definition equates goodwill with a rate of return on investment which is above normal returns in the industry and limits it to the residual intangible asset that generates earnings in excess of a normal return on all other tangible and intangible assets. *In this court for tax purposes, the intangible value of a business is divisible into its identifiable constituent elements. . . . The most significant indication that an intangible asset is separate and distinct from goodwill is whether its useful life can be shown with reasonable accuracy to be of limited duration. The most important criterion is whether in fact it is a wasting asset.*

Richard S. Miller, 537 F.2d at 450-52 (citations omitted) (emphasis added).

There are also a few cases that, like *Donrey*, provide implicit, and consequently somewhat less persuasive, authority for Morning Ledger's asserted definition of goodwill. In *Super Food Services, Inc. v. United States*, 416 F.2d 1236 (7th Cir. 1969), for example, the taxpayer, who had purchased a supermarket chain as ongoing business, was permitted to depreciate, as an intangible asset, 184 terminable-at-will retail franchise contracts acquired as part of the deal. The implicit reasoning of the court was that,

having demonstrated that the contracts had limited useful lives, and having provided a reasonable estimate of those lives, the taxpayer was not obligated further to prove that the contracts were distinct from the goodwill value of the acquiree. *See also Business Service Industries, Inc. v. Commissioner*, 51 T.C.M. (CCH) 539, 543 (1986) (upholding taxpayer's claimed depreciation deductions for acquired terminable-at-will MUZAK customer contracts on implicit ground that it was sufficient that taxpayer had demonstrated that contracts had ascertainable value and useful life).

Still other cases appear confused in their analyses, ultimately providing support for both conflicting definitions advanced in the case at bar. In *Los Angeles Central Animal Hospital, Inc. v. Commissioner*, 68 T.C. 269, 273-74 (1977), for example, the Tax Court noted, consistent with the Service's position here, that goodwill is typically defined as the expectancy that "old customers will resort to the old place of business." *Id.* at 273 (citations omitted). Seemingly switching definitions of goodwill in midstream, the court then held that the taxpayer could depreciate the cost of 12,000 medical record cards purchased as part of the sale of a veterinary practice.

> From those [medical] records, the operator of the business is able to generate business by contacting the pet owners whose animals require periodic immunization and innoculation. The "repeat business" which was obtained through the use of these records was not dependent solely on the normal elements of "goodwill." These specific records do not retain their value indefinitely as part of the continuing operation of the practice.

Id. at 274.

The strongest authority mustered by Morning Ledger in support of its argument is the recent memorandum decision of the Tax Court in *Colorado National Bank-*

shares, Inc. v. Commissioner, 60 T.C.M. (CCH) 771 (1990).[7a] The case involved the depreciability of so-called "core deposits" (i.e., checking account and saving account deposits) following the acquisition of the assets and accounts of one bank by another. On the theory that such deposits represent a valuable source of prospective income to a bank—inasmuch as the deposits are obtained at no or relatively low cost but can be continuously reinvested by the bank at higher rates of return—the acquiror bank sought to depreciate the portion of the purchase price attributable to the core deposits as an intangible asset. In an attempt to satisfy the requirements of § 1.167(a)-3, the acquiror bank employed sophisticated financial and statistical methods to estimate the average length of time that depositors would maintain their deposits and, based on these estimates, to calculate the total net value of the core deposits.

The Service responded that, in effect, the acquiror bank was attempting to depreciate the value of its expectation that the depositors would continue to patronize the bank—i.e., the value of the goodwill of the acquired bank. The Tax Court rejected the Service's position, clearly adopting the view that any intangible asset possessing a determinable life and an ascertainable value is, by definition, not goodwill.

> Goodwill, by definition, has an indefinite life and is valued using the residual method. By contrast, the deposit accounts of the acquired banks could be, and were, identified; had limited lives that could be estimated with reasonable accuracy; and could be, and have been, valued directly with a fair degree of accuracy. Moreover, petitioner's deposit accounts were not self-regenerating. Therefore, the deposit accounts were assets with values separate and apart from goodwill. It is these characteristics which separate them from general goodwill and permits separate valuation. We conclude that petitioner has proven that the core deposits intangible at issue here has an ascertainable cost basis separate and distinct from the goodwill and going-concern value of the acquired banks.

[7a] The parties called to our attention in the Petition for Rehearing that the Eleventh Circuit has, in a published opinion, summarily affirmed the reasoning of a published Tax Court Opinion, *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) (per curiam), which essentially tracks the reasoning of *Colorado National*. Although there now appears to be a Circuit split on this issue, for the reasons set forth in the text, we respectfully disagree with the Eleventh Circuit's position.

Colorado National, 60 T.C.M. (CCH) at 789 (citations omitted).

We could attempt to distinguish *Colorado National* and *Citizens & Southern* from the instant dispute. We believe, however, that such an exercise ultimately would prove pointless and would be somewhat disingenuous. The unavoidable fact is that there does exist authority bolstering Morning Ledger's position.

It is equally clear, however, that *Colorado National* and the other cases referenced by Morning Ledger represent no more than a minority strand amid the phalanx of cases that have considered the definition and application of the term "goodwill" in the context of § 1.167(a)-3, and which support the Service's position. *See, e.g., Brooks v. Commissioner*, 36 T.C. 1128, 1133 (1961) (defining goodwill as " 'the probability that old customers will resort to the old place' " (quoting *Horton v. Commissioner*, 13 T.C. 143, 148 (1949), *acq. and petition dismissed*, 180 F.2d 354 (10th Cir. 1950))); *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962) ("essence of good will is the expectancy of continued patronage, for whatever reason"); *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897, 901 (5th Cir. 1962) ("good will [is] the probability that the old customers will resort to the old place"); *Commissioner v. Killian*, 314

F.2d 852, 855 (5th Cir. 1963) (quoting *Nelson Weaver*); *Commissioner v. Seaboard Finance Co.*, 367 F.2d 646, 649 (9th Cir. 1966) (quoting *Boe* and *Brooks*); *Golden State Towel and Linen Service, Ltd. v. United States*, 373 F.2d 938, 941, 179 Ct. Cl. 300 (1967) (quoting *Boe*); *Skilken v. Commissioner*, 420 F.2d 266, 270 (6th Cir. 1969) (" '[Goodwill] . . . is constituted in the tendency of customers to return for trade to those with whom they are accustomed to deal.' " (quoting *Burke v. Canfield*, 121 F.2d 877, 880 (D.C. Cir. 1941)); *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 681 (5th Cir. 1971) ("[G]oodwill is acquired by the purchaser of a going concern where the 'transfer enables the purchaser to step into the shoes of the seller,' " (quoting *Balthrope v. Commissioner*, 356 F.2d 28, 32 n.1 (5th Cir. 1966)); *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1247 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129, 94 S. Ct. 867, 38 L. Ed. 2d 754 (1974) (quoting *Nelson Weaver, Boe,* and *Balthrope*); *Robins & Weill, Inc. v. United States*, 382 F. Supp. 1207, 1214 (M.D.N.C. 1974) (quoting *Killian*); *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223, 233 (1975), *acq.*, 65 T.C. 1153 (1976) (essence of goodwill is a preexisting business relationship, based on a continuous course of dealing, which may be expected to continue indefinitely); *Los Angeles Central Animal Hospital, Inc. v. Commissioner*, 68 T.C. 269, 273 (1977) (citing *Houston Chronicle, Killian, Boe,* and *Computing & Software, Inc.*); *General Television, Inc. v. United States*, 449 F. Supp. 609, 612 (D. Minn. 1977) *aff'd*, 598 F.2d 1148 (8th Cir. 1979) ("the expectancy of continued patronage is the essence of goodwill"); *Illinois Cereal Mills, Inc. v. Commissioner*, 46 T.C.M. (CCH) 1001, 1023 (1983), *aff'd*, 789 F.2d 1234 (7th Cir. 1986), *cert. denied*, 479 U.S. 995, 107 S. Ct. 600, 93 L. Ed. 2d 600 (1986) (citing *Seaboard Finance Co.* and *Computing & Software, Inc.*); *Banc One Corp. v. Commissioner*, 84 T.C. 476, 508 (1985), *aff'd without opinion*, 815 F.2d 75 (6th Cir. 1987) (quoting *Boe*); *Decker v. Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988) (quoting *Winn-Dixie*); *AmSouth Bancorporation and Subsidiaries v. United States*, 681 F. Supp. 698, 712 (N.D. Ala. 1988) (quoting *Houston Chronicle*).

A brief review of the application of this definition to the facts of a few of these cases demonstrates convincingly that the Service has more accurately characterized the prevailing case law in relation to the facts of the current dispute. In *General Television, Inc. v. United States*, 449 F. Supp. 609 (D. Minn. 1977), *aff'd*, 598 F.2d 1148 (8th Cir. 1979), for example, the taxpayer purchased two community antenna television (CATV) stations. Among the assets of the two stations were over 7,000 at-will subscriber contracts, which the taxpayer sought to depreciate as intangible assets. When the Service disallowed the depreciation deductions, the taxpayer paid the tax and filed a refund suit. The district court, viewing the totality of the subscriber contracts as essentially a customer or subscriber list, denied the taxpayer's request stating:

> It is true that certain types of customer or subscriber lists have an ascertainable value separate and apart from goodwill. However, in the instances in which customer or subscriber lists have been determined to have an ascertainable value separate and apart from goodwill, the lists alone carried with them no expectancy of continued patronage. In the present case, what the plaintiff purchased was more than mere subscriber lists which could be used to identify potential customers; what it purchased was customer structures which included the expectancy of continued patronage. Therefore, because the purchases of the subscriber lists were actually purchases of customer structures with the expectancy of continued patronage and because the expectancy of continued patronage is the essence of goodwill, the subscriber lists constitute non-depreciable goodwill.

Id. at 611-12 (citations omitted).

Similarly, in *Panichi v. United States*, 834 F.2d 300 (2d Cir. 1987), the Second Circuit upheld a district court ruling that a taxpayer who purchased a list of customers from a trash collection business was entitled to depreciate the value of the list. The court was careful to note that the list was depreciable because the taxpayer had not acquired it as part of a going concern. Thus, there was no possibility that the value of the list reflected the value of the seller's goodwill. *Id.* at 301-02.[8]

Finally, it is worth noting the decision in *AmSouth Bancorporation and Subsidiaries v. United States*, 681 F. Supp. 698 (N.D. Ala. 1988), a case which, like *Colorado National* and *Citizens & Southern*, considered the depreciability of core deposits, or customer deposit base, in the context of a bank acquisition. By opting for the traditional definition of goodwill in the tax context, *AmSouth* arrives at a hold-

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[8] Additionally, in *Robins & Weill, Inc. v. United States*, 382 F. Supp. 1207 (M.D.N.C. 1974), one of the first cases to apply *Houston Chronicle's* two-pronged standard, the court considered the depreciability of acquired insurance "expirations," which are essentially records of when existing policyholders' coverage will expire and thus of when an opportunity to write new policies will arise. After invoking the oft-repeated definition of goodwill as "the expectancy that old customers will resort to the old place" and "the expectancy of continued patronage, for whatever reason," *Id.* at 1214, the court noted that the taxpayer had purchased expirations from two different agencies. In one of these purchases, the court reasoned, the taxpayer sought the expirations solely for their informational value, and had not purchased the rights to the prior agency's personnel, trade name, business location, or other components of goodwill. The court therefore concluded that these expirations were *not*, in fact, goodwill and thus were depreciable. The purchase of the other agency's expirations, however, was made in conjunction with the complete transfer of the employees, trade name, office location, reputation, and customer structure of the acquired agency. The court therefore was of the view that goodwill of far greater value than the $10 amount claimed by the parties had been transferred in the sale. Consequently, the court held that the taxpayer had failed to satisfy its burden of demonstrating a value for the expirations that was "separate and distinct from goodwill." *Id.* at 1215.

ing directly at odds with the Tax Court's holdings in *Colorado National* at [21a-22a] and *Citizens & Southern*, *see supra* n.8. While we recognize that the validity of *AmSouth* is questionable after the Eleventh Circuit's decision in *Citizens & Southern*, we find the reasoning of *AmSouth* sufficiently persuasive and well-articulated to merit quoting from the case at length.

> When deposits are made, two accounting entries result. First, there is a debit (asset) entry for cash or its equivalent. Second, there is an equal and offsetting credit (liability) entry for the liability to the depositor. Any additional asset must be different from the cash thereby acquired. Its creation must, somehow, result from the expectation that the depositor will allow the cash, or its equivalent, to *remain* as an asset and that earnings will result therefrom. This expectation is akin to, if not tantamount, to the expectancy that "old customers will resort to the old place" of business or continued "customer patronage." The "additional" asset does not just materialize out of nowhere. It is geared to the expectancy of the *continued* deposit relationship (patronage). . . .
>
> For accounting purposes, a bank may be able to "identify" a customer deposit base even though it may not be separate and distinct from goodwill. To the extent that deposits remain after some contractually stipulated period, they result from, "continued patronage." The mere fact that the deposits themselves are identifiable, does not make their *"value"* separate and distinct from goodwill. Other facets of bank activities such as safe deposit "expectations," loan "expectations," etc. could perhaps be similarly "identified" so as to phase out the concept of goodwill. There is no indication that tax law permits or contemplates this result.

Id. at 720 (citations omitted) (emphasis in original).

D. *Conclusion*

We do not deny the analytic force of *Colorado National's* residual approach to defining and calculating goodwill. And there is no doubt that many of the commentators would prefer to see the Service and the case law move in this direction, in contrast to the "expectation of continued patronage" standard to which the Service clings.[9] We would be hard pressed, however, after at least thirty years during which: (1) the Service consistently has advanced its definition; (2) courts have overwhelmingly acquiesced to it; and (3) the Congress, the Treasury and the Service, wherein reside the authority and expertise to undertake such a change, have stood mute, to take it upon ourselves to announce a sudden redefinition of a concept so fundamental to tax accounting. In any case, consistent with the prevailing case law, we believe that the Service is

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[9] The following passage is representative of the position taken by many of the commentators:

> In a sense, "goodwill" may be defined as all intangible commercial advantages which have not been specifically identified, valued and analyzed as to their useful lives. The sphere of acquired competitive advantages began its existence in the tax law as being composed entirely of the element labeled "goodwill." Taxpayers, lured by the prospects of cost recovery through amortization, have been able to peel away at the sphere by utilizing sophisticated and objective methods for determining the purchase price before the acquisition or for allocating the price after the fact. In this way, the taxpayer has been able to identify more and more of the intangible advantages for which he has paid money in excess of the value of tangible assets. If the trend continues, theoretically taxpayers should be able to whittle down the sphere so that the core of goodwill becomes non-existent by identifying and allocating the entire excess price to specific competitive advantages. The [only] obstacle to be hurdled for each newly-identified element will be the burden of proof regarding allocation of value and determinable life.

Gregorcich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 Tax Law. 251, 270-71 (1975) (citation omitted).

correct in asserting that, for tax purposes, there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable. We conclude, in short, that the district court applied the wrong definition of "goodwill."

We conclude additionally that, applying the correct definition of goodwill, it is clear that Morning Ledger has not satisfied its burden of demonstrating that the paid subscribers are "separate and distinct from goodwill." As the cases discussed *supra* demonstrate, the depreciability of customer lists, while no longer *per se* forbidden under the mass asset rule, still is limited to a narrow set of circumstances. Customer lists are generally not depreciable when acquired in conjunction with the sale of the underlying business as a going concern. In the context of the sale of a going concern, it is simply often too difficult for the taxpayer and the court to separate the value of the list *qua* list from the goodwill value of the customer relationships/structure.

Even in those cases where customer lists have been deemed depreciable, the value assigned to the lists has been limited to the *cost* of generating a like list of potential subscribers or customers. As a general matter, the courts have not permitted customer lists to be valued as the stream of *income* to be generated by the listed customers over their remaining years of patronage. We agree. We note, moreover, that this preference for the cost approach over the income approach is not premised merely on some obscure aspect of financial theory. The difference in valuations between the cost and income approach, of course, can be substantial. In this case, the Service offered expert testimony that the 460,000 subscribers to the Booth newspapers could be valued on a cost basis at roughly $3 million, whereas Morning Ledger's experts valued the same subscribers on an income basis at over $67 million! More importantly, this difference in the two valuation ap-

proaches implicates the central legal dilemma at issue. The fact is that, when employed in the context of the sale of an ongoing concern, the income approach to valuing a list of customers inherently includes much or all of the value of the expectancy that those customers will continue their patronage—i.e., the goodwill of the acquired concern.

We do not decide whether Morning Ledger could have argued successfully that it was entitled to assign a reasonable cost basis to the list (e.g., the government's $3 million estimate of what it would cost to generate a similar list as a marketing tool) and to depreciate it as an intangible asset, notwithstanding that the list was acquired as part of a going concern. This argument has never been before the court in this case, even as an alternative claim. Morning Ledger apparently never has been satisfied to seek cost recovery on such a small portion of the premium it paid over the value of Booth's tangible assets. Instead, it gambled on persuading the court of the merits of its view of the definition of goodwill and the related case law in the hopes of securing the right to recover through depreciation some $67 million. In our view, however, under the proper definition of goodwill, the $67 million amount established by Morning Ledger is quite clearly comprised largely, if not exclusively, of amounts properly attributable to goodwill. As such, Morning Ledger has not satisfied its burden of proving a value for its so-called paid subscribers that is separate and distinct from goodwill, and the district court's finding to the contrary is clearly erroneous.

The judgment of the district court will be reversed, and the case remanded with instructions to enter judgment in favor of the United States.

A True Copy:
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Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B

Civ. A. No. 88-4846.

United States District Court

D. New Jersey

NEWARK MORNING LEDGER CO., as Successor to the Herald Company, Star Ledger Plaza, Newark, New Jersey 07101,

Plaintiff,

v.

THE UNITED STATES OF AMERICA,

Defendant.

April 3, 1990.

In action contesting disallowance of depreciation deductions, the District Court, Sarokin, J., held that acquisition of existing paying subscribers as part of ongoing group of newspapers warranted tax deduction for depreciation and amortization of value of those subscribers as assets separate and apart from goodwill.

Order accordingly.

* * * * * *

Donald A. Robinson, Albert H. Turkus, Robinson, Wayne & LaSala, Newark, N.J., for plaintiff.

Gregory S. Hrebiniak, Dept. of Justice, Tax Div., Washington, D.C., for Defendant.

OPINION

SAROKIN, District Judge.

Introduction

This action involves the issue of whether the acquisition of existing paying subscribers as part of an ongoing group

of newspapers warrants a tax deduction for the depreciation and amortization of the value of those subscribers as an asset separate and apart from goodwill.

The parties concede that the issue is a factual one, and that in order to prevail plaintiff has the burden of proving that as of May 31, 1977, said subscribers had limited useful lives, the duration of which can be estimated with reasonable accuracy, and ascertainable values separate and apart from goodwill.

The court finds, as more specifically hereinafter set forth, that plaintiff has met its burden. In summary, it is self-evident that the subscribers themselves as of a certain date have limited useful lives, because the subscriptions by necessity will terminate upon the death of their respective subscribers. Secondly, plaintiff has presented competent evidence that the subscriptions also have limited useful lives and will terminate for a variety of other reasons prior to the death of their respective subscribers. Either based upon the inevitable death of the *subscribers* or the statistical evidence submitted by plaintiff and the uncontroverted expert opinions that the *subscriptions* have limited useful lives which can be estimated with reasonable accuracy, plaintiff has clearly established that the paying subscribers (or subscriptions) of the acquired newspapers had limited useful lives, the duration of which can be and has been estimated with reasonable accuracy. Indeed, the parties have entered into a stipulation establishing the useful lives of the subscribers for each of the newspapers involved, in the event that this court finds for the plaintiff.

As to the second prong, the court recognizes and accepts that goodwill is the expectancy that former customers will be retained—that there will be continued patronage. However, one must distinguish between a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity and future purchases cannot be predicted, against subscribers who can be predicted to purchase the same item, for the same price on a daily basis. Although newspaper subscribers are under no legal obligation to continue their subscriptions, expert opinion and the evidence presented coupled with common sense and experience leads inescapably to the conclusion that the income derived from such paying subscribers will recur, which, in turn, permits the ascertainment of value separate and apart from goodwill. The income derived from the subscribers permits the calculation of value over the useful lives of the subscriptions or subscribers, and renders the subscribers acquired subject to valuation as an asset separate and apart from goodwill.

Discussion

The following shall constitute the court's findings of facts and conclusions of law:

Findings of Fact

Plaintiff, Newark Morning Ledger Co. ("Morning Ledger"), is a corporation organized and existing under the laws of the State of New Jersey with its principal place of business in Newark, New Jersey. Stip. para. a. Morning Ledger is a successor by merger to The Herald Company ("Herald") which, prior to its merger into Morning Ledger, published daily newspapers in eight Michigan communities, *inter alia* (the "Booth newspapers"). Stip. para. b,c.

This income tax case involves Herald's claim to depreciation deductions with respect to assets useful in its business, i.e., the existing relationships with the subscribers of the Booth newspapers acquired on May 31, 1977 (sometimes referred to as the "paid subscribers"). Herald claimed deductions for depreciation with respect to those subscriber relationships when it filed its tax returns for the taxable years 1977 through 1980. The Internal Revenue Service (the "Service") disallowed those deductions,

thereby determining an increased tax liability for Herald for each of those years. The correctness of those depreciation deductions is the subject of this action.

During the period beginning February 12, 1976 and ending November 5, 1976, Herald purchased all the outstanding stock of Booth Newspapers, Inc. ("Booth"). Stip. para. e. Booth was a Michigan corporation with its principal place of business in Ann Arbor, Michigan. Booth published the following daily and Sunday paid-circulation newspapers in eight Michigan communities: Ann Arbor News, Bay City Times, Flint Journal, Grand Rapids Press, Jackson Citizen Patriot, Kalamazoo Gazette, Muskegon Chronicle, and Saginaw News. Stip. para. c. On the May 31, 1977 acquisition date, these newspapers had a total of approximately 460,000 subscribers. Stip. para. j. In addition to publishing the Booth newspapers, Booth owned all the stock of the Parade Publications, Inc. ("Parade"), which published a nationally-distributed Sunday newspaper supplement called *Parade*. Stip. para. c.

Prior to Herald's purchase of Booth, Booth's stock was publicly traded. Herald purchased two blocks of Booth stock through private sales, and later made a tender offer for all of the outstanding stock.

Herald did not obtain an appraisal of any of the Booth assets prior to purchasing the Booth stock. Generally, such appraisals are made subsequent to such a purchase according to Roger J. Grabowski.[1] Before purchasing Booth, however, Herald's officers inquired into the financial and other relevant aspects of Booth's operations and met with Booth's Chief Executive Officer. The decision to purchase the Booth stock and the determination of the price to be paid for that stock were influenced by the fact that the

[1] Mr. Grabowski is an expert in valuation theory and methodology, in particular in the valuation of intangible assets in ongoing businesses, in the media industry among others, and in the valuation of customer base assets.

Booth newspapers were paid-circulation newspapers and by the number of subscribers to those newspapers.

On May 31, 1977, Booth was liquidated into Herald by merger in a transaction governed by sections 332 and 334(b)(2) of the Internal Revenue Code of 1954, as amended (the "Code"). Stip. para. c. Subsequently, on June 30, 1987, Herald was merged into Morning Ledger, making the operations of Herald and Booth unincorporated divisions of Morning Ledger. Stip. para. b.

As a consequence of the liquidation of Booth into Herald, pursuant to the rules set forth at section 1.334-1(c)(4)(vi)(b) of the Treasury regulations, Herald's adjusted tax basis in the Booth stock had to be allocated among the assets of Booth in proportion to their respective fair market values as of May 31, 1977. In filing its tax returns for calendar and taxable years 1977 through 1980, Herald claimed depreciation deductions with respect to the paid subscribers of the Booth newspapers. These deductions were calculated by reference to Herald's adjusted basis in the paid subscribers derived from the application of the foregoing rules. The Service disallowed those deductions. Herald paid the additional taxes and interest determined by the Service to be due. Stip. para. d.

Morning Ledger, as successor to Herald, filed a timely claim for refund of taxes and interest previously paid for taxable years 1977 through 1980. Stip. para. m. Pursuant to section 6532(a) of the Code, the Service had six months in which to act upon the claim before suit could be brought. The six-month period expired without action by the Service. Stip. para. n. Morning Ledger timely filed this action to recover federal income taxes and interest which it alleged were erroneously assessed and collected by the Service for those taxable years. Stip. para. o.

The total fair market value of the assets acquired by Herald in the liquidation of Booth was $313,997,154. Herald's total adjusted tax basis in these assets was

$328,173,154. Stip. para. f. The assets were of three types: (1) cash, cash equivalents, and other financial assets including securities, accounts and notes receivable, and deferred charges and deposits; (2) tangible and intangible assets of the Booth newspapers publishing operations including land, land improvements, buildings, equipment, furniture, fixtures, vehicles, paid subscribers, computer software, going concern value, and goodwill; and (3) the stock of Parade. Stip. para. g.

On May 31, 1977, the fair market values and adjusted tax bases of certain of the assets acquired by Herald in the liquidation of Booth were as follows:

Assets	Fair Market Value	Adjusted Tax Basis
Cash and Equivalents	$ 15,617,042	$ 15,617,042
Securities	37,249,852	39,134,189
Accounts and Notes Receivable	15,046,899	15,046,899
Master Repurchase Agreements	3,100,000	3,100,000
Deferred Charges and Deposits	323,944	340,331
Inventories	3,435,627	3,609,423
Land	4,658,885	4,894,561
Land Improvements	1,721,959	1,809,067
Buildings and Improvements	21,350,237	22,430,269
Production Equipment	17,109,130	17,974,620
Computer Hardware	1,300,435	1,366,219
Furniture and Fixtures	880,775	925,330
Office Equipment	731,195	768,184
Autos and Trucks	234,489	246,351
Computer Software	1,658,000	1,741,872
Stock of Parade	100,000,000	105,058,644

Stip. para. h.

The parties have agreed that on May 31, 1977, the total fair market value of the remaining three intangible assets, i.e., the paid subscribers, the going concern value and goodwill of the papers, was $89,578,685 and the total adjusted tax basis to be allocated pro rata to those assets,

pursuant to section 1.334-1(c)(4)(vi)(b) of the Treasury regulations, was $94,110,152, although the government contests that the paid subscribers were assets separate and apart from goodwill. Stip. para. i.

The parties have stipulated that the value of the going concern and goodwill of Booth newspapers will be determined using the residual method, Stip. para. i., the method of valuation generally utilized by the Service and valuation experts to value such assets, according to Larry D. Berkey.[2] Consequently, this court need not determine, based upon direct evidence, the value of goodwill and going concern. The aggregate fair market value of the going concern and goodwill of the Booth newspapers is the difference between $89,578,685 and the fair market value of the paid subscribers of the Booth newspapers, as determined by this Court, assuming that this Court finds that the paid subscribers are assets separate and apart from goodwill. The adjusted tax basis of the paid subscribers of the Booth newspapers is the same proportion of $94,110,152 as the fair market value of the paid subscribers is of $89,578,685. Stip. para. i. The aggregate adjusted tax basis of the going concern and goodwill of the Booth newspapers is the difference between $94,110,152 and the adjusted tax basis of the paid subscribers of the Booth newspapers. Stip. para. i.

All of the foregoing facts are admitted and undisputed. As to the remaining facts in dispute, the court makes the following specific findings:

Advertising provides approximately eighty percent of most newspapers' revenues, including the Booth newspapers. In order to earn advertising revenue, newspapers

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[2] Mr. Berkey also is an expert in valuation theory and methodology, in particular in the areas of the valuation of intangible assets in ongoing businesses, in the media industry among others, and in the valuation of customer base assets.

are required to produce a newspaper that contains news, entertainment and advertising that is interesting to the readers, according to Dr. Christine D. Urban.[3] Some newspapers generate subscription revenue; others do not.

There are basically two types of newspapers, those with a paid circulation, where the newspapers are sold to the readers, and those which are known as free-distribution newspapers, which are provided to the readers without any charge. Within both categories, there are daily newspapers and newspapers published on a less frequent basis, such as weekly, although free daily newspapers are very rare. Included in the two types of newspapers are shoppers, mailers, weeklies, dailies, business journals, nationals, trade papers, etc., which vary in content, size, format and distribution. The principal difference between the two kinds of newspapers is the fact that paid-circulation newspapers have circulation revenues. Paid circulation can be either on a subscription basis or on a single copy basis, such as at newsstands or through coin boxes. In the case of the Booth newspapers, approximately 20 percent of their total revenues come from circulation revenue, as was the case in 1977. In 1977, approximately 85 percent of the circulation revenue was from subscribers; the balance came from single copy sales. Sales to subscribers were, and are, important to the Booth newspapers because subscriber income is regular and predictable.

On May 31, 1977, the paid subscribers of the Booth newspapers consisted of approximately 460,000 particular customers who had requested that one of the Booth newspapers be delivered to a specific address on a regular basis in return for payment of the subscription price. The number of paid subscribers of each of the Booth newspapers was as follows:

[3] Dr. Urban is an expert in the newspaper industry, including, in particular, consumer behavior, market trends, and operational matters, such as strategic planning, financial forecasting, circulation strategy, advertising strategy, and news and editorial content and redesign.

Newspaper	Daily Subscribers	Sunday Subscribers
Ann Arbor	37,743	37,122
Bay City	37,337	36,255
Flint	91,366	91,155
Grand Rapids	120,011	106,859
Jackson	35,711	35,632
Kalamazoo	51,481	52,960
Muskegon	41,203	40,609
Saginaw	49,327	48,942

Stip. para. j. The name and address of each paid subscriber was retained by Booth or on its behalf by persons responsible for delivery of the papers. Stip. para. j.

The parties have agreed that, if the Court determines that the paid subscribers constitute assets which were separate and apart from goodwill and which can be valued separate and apart from goodwill, and if the Court determines that the paid subscribers had useful lives which can be estimated with reasonable accuracy, then the paid subscribers of the Booth newspapers can be depreciated on a straight-line basis over the following useful lives:

Newspaper	Useful Lives of Daily Subscribers	Useful Lives of Sunday Subscribers
Ann Arbor	14.7	14.7
Bay City	22.2	23.4
Flint	18.3	18.5
Grand Rapids	17.7	21.2
Jackson	17.9	18.9
Kalamazoo	17.0	17.6
Muskegon	18.0	16.2
Saginaw	17.4	18.3

Stip. para. k.

A. Limited Life of the Asset

It is undisputed that all the paid subscribers of the Booth newspapers as of May 31, 1977 would, at some point in time, no longer be subscribers. That fact was recognized by those familiar with Booth, by the members of the Newhouse family when they decided that Herald would purchase Booth, and by those familiar with the newspaper industry generally. Subscribers are lost because of death, relocation, lack of reader time or interest, changing lifestyles, and other factors that are beyond the control of the newspapers. Also, subscribers are lost due to dissatisfaction with the product or service and for various other reasons, including competition from other media sources, such as radio, television, magazines and other paid-circulation and/or free-distribution newspapers.

Defendant contends that the number of subscribers of each of the Booth newspapers, both daily and Sunday, increased from 1977 through the present. Even if true, whether or not new subscribers were added after the date of valuation is not relevant to the nature and value of the asset as of May 31, 1977.

The paid subscribers of the Booth newspapers acquired by Herald on May 31, 1977, were not self-regenerating, i.e., there is no automatic replacement for a subscriber who terminates his or her subscription. Although the total number of subscribers may have or has remained relatively constant, the individual subscribers will not and have not remained the same, and those that may or have discontinued their subscriptions can be or have been replaced only through the substantial efforts of the Booth newspapers. Moreover, because subscribers turn over so frequently, newspapers throughout the country must sell many new subscriptions each year just to maintain their total number of subscribers.

The government's contention that such findings are irrelevant is rejected by the court. The relevance of Morning

Ledger's evidence regarding the substantial costs and efforts required to replace lost subscribers demonstrates that the subscribers are not self-regenerating assets. The fact that the expenses that are incurred in maintaining an asset are deductible does not mandate a finding that the asset itself is not depreciable. Notwithstanding the time consuming and expensive efforts made to generate new subscribers, the penetration of the Booth newspapers, i.e., the percentage of total households in their markets subscribing to the newspapers, has declined significantly over the last 20 years.

In 1977 and 1978, Statistical Research, Inc. ("SRI") and Professor Gerald J. Glasser[4] conducted a study of the paid subscribers of the Booth newspapers as of May 31, 1977. Report of Statistical Research, Inc., "Report on the Average Remaining Life of Subscriptions to Booth Newspapers". Using the methodology described by Dr. Glasser and utilized in his study, which relied upon widely accepted statistical techniques, the court finds that the remaining useful lives of the paid subscribers of the Booth newspapers as of May 31, 1977, could be estimated with reasonable accuracy.

Defendant contends that what Dr. Glasser presented to the Court was a mortality table of subscribers *at a particular address*, not a mortality table of the total subscriptions, and that he calculated the mortality table using only the data directly collected in the survey and from no other subscription data, not even data that Booth had already collected. Defendant further urges that Dr. Glasser did not ask the relevant question, "For how long have you been (or intend to be) a subscriber to the newspaper?"

However, because of the stipulation reached by the parties, Morning Ledger need not prove either the specific

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[4] Dr. Glasser is an expert in statistics, including statistical theory, statistical methods and their applications, sampling, data analysis and survey research.

useful lives of the paid subscribers of the Booth newspapers as of May 31, 1977, or that Dr. Glasser has correctly estimated those lives. In light of the stipulation, defendant's argument with regard to Dr. Glasser's estimation of the specific useful lives of the Booth subscribers is wholly irrelevant. Instead, Dr. Glasser's testimony establishes that qualified experts could estimate with reasonable accuracy the remaining useful lives of the paid subscribers of the Booth newspapers as of May 31, 1977.

As to the question asked, Dr. Glasser explained that the same methodology that he utilized, which is generally accepted by statistical experts, could have been utilized in asking a different question, and such a survey would likewise have led to reasonably accurate estimates of the useful lives of the Booth subscribers.

B. Valuing the Asset

There were three basis valuation approaches that might have been utilized to determine the fair market value of the paid subscribers of the Booth newspapers as of May 31, 1977; the market approach, the cost approach, and the income approach.

Subscribers to an ongoing newspaper are not commonly sold except as part of a sale of the newspaper operation. Accordingly, there was insufficient data available to permit use of the market approach to determine the fair market value of the paid subscribers of the Booth newspapers as of May 31, 1977.

Although it was possible to estimate the direct cost of soliciting additional subscribers to the Booth newspapers, those subscribers if obtained were not and would not have been comparable, in terms of life characteristics or value, to the paid subscribers of the Booth newspapers as of May 31, 1977. Furthermore, complete data as to the total cost of obtaining even such marginal subscribers had never been compiled. The cost of generating such marginal subscribers

would not reflect the fair market value of the existing subscribers of the Booth newspapers as of May 31, 1977. Accordingly, the cost approach could not and should not be used to determine the fair market value of the paid subscribers of the Booth newspapers as of May 31, 1977.

In response to the expert opinions submitted by plaintiff, defendants offered experts who were unqualified, valued the wrong asset and utilized inappropriate methodology.[5]

Defendant asserts that the cost approach is the only valid method of determining the value of any asset relating to the subscribers of the Booth Newspapers as of May 31, 1977. The government submitted expert opinion that every household in the Booth markets could have been solicited for a cost of $3,000,000, and that the result would be to reconstruct the exact set of subscribers, and that the actual cost to recreate the set of subscribers would actually be far less since, conservatively, 40% of all subscribers would have initiated their own subscription.

The cost of obtaining subscribers does not equate with their value to the enterprise. The court finds that the income approach is, in fact, what buyers and sellers would utilize to determine the price at which these assets would change hands. The government's contention totally ignores the substantial efforts and expenses that had been invested over the years in establishing those subscriber relationships.

The income approach is commonly used to value intangible assets of a going business, other than goodwill and going concern value. This approach best reflects the method that buyers and sellers would utilize to determine

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[5] Plaintiff has moved to strike the testimony of defendant's experts. Despite the above finding, the court concludes that (there being no jury) no useful purpose would be served in striking such testimony. On appeal, the appellate court will make its own determination as to the qualifications and testimony of defendant's experts.

the price at which such assets would change hands. Plaintiff's experts presented testimony that buyers and sellers would determine the additional value of the Booth newspapers attributable to the existence of the paid subscribers as of May 31, 1977, and, thus, the price to be paid for those subscribers, by calculating the present value of the net revenue stream they would provide over their limited lives, i.e., the subscription revenue less the cost of collecting that revenue. That methodology, they testified, produces the fair market value of the paid subscribers of the Booth newspapers as of May 31, 1977.

Defendant, however, contends that this method does not use a portion of the net income or profit of a business, but rather an entire revenue stream unencumbered or reduced by appropriate costs and expenses, and that the only subtractions from the subscriber revenue stream were the costs associated with delivery and collection.

As such, defendant argues that the income method of valuation as used by plaintiff is unacceptable and the produced values are not persuasive. Defendant contends that there are additional costs which plaintiff never identified or even considered, for instance, an apportioned cost of producing the newspaper, since a sale of a newspaper and the income derived from the sale is not independent of the cost of producing the paper.

During the trial, the court on numerous occasions questioned the propriety of valuing the subject asset without making any adjustments or deductions for production costs, overhead expense, etc. Although the government raises the same questions, it offered no competent evidence to the court upon which the court could base any finding to reduce plaintiff's evidence of valuation. Absent such evidence the court cannot speculate as to what deductions would be appropriate and how they would impact upon the overall valuation. Plaintiff, on the other hand, presented evidence that their experts' methodology was fully in accordance

with generally accepted valuation principles, and the validity of their analysis was supported by the detailed expert testimony of Dr. Urban. Furthermore, Mr. Berkey explained that he had tested his conclusions by a second income approach methodology that included allocating the relevant share of all costs, and that exercise confirmed his initial valuation conclusion. Accordingly the court accepts both the methodology and valuations submitted by plaintiff's experts.

C. Distinguishing Goodwill and Fixing Value

As to whether this is an asset separate and apart from goodwill, "goodwill" is the expectancy that the old customers will resort to the old place. The essence of goodwill is the expectancy of continued patronage, for whatever reason. Goodwill is acquired by the purchase of a going concern where the transfer enables the purchaser to step into the shoes of the seller.

Goodwill, by definition, has an indefinite life and is valued using the residual method. By contrast, the paid subscribers of the Booth newspapers as of May 31, 1977, could be, and were, identified; had limited lives that could be estimated with reasonable accuracy; and could be, and herein have been, valued directly. Moreover, the paid subscribers of the Booth newspapers as of May 31, 1977, were not self-regenerating. Therefore, the paid subscribers of the Booth newspapers as of May 31, 1977, were assets with values separate and apart from goodwill.

As stated at the outset, paid subscribers are distinct from previous customers who may or may not return, who may buy more or less or nothing at all. They are identifiable; how long they will remain as subscribers can be predicted with reasonable accuracy; and their value can be measured with a fair degree of accuracy. It is these unique characteristics which separates them from general goodwill and permits of a separate valuation.

To ascertain the fair market values of the paid subscribers of the Booth newspapers, Morning Ledger's valuation experts, Messrs. Larry D. Berkey and Roger J. Grabowski, used a widely accepted application of the income approach to valuation. Specifically, they computed the present value of the after-tax subscription revenues to be derived from the paid subscribers, less the cost of collecting those revenues, and added the present value of the tax savings resulting from the depreciation of the paid subscribers. Both Mr. Berkey and Mr. Grabowski utilized this method because they each independently concluded that this method best determined the additional value of the Booth newspapers attributable to the existence of the paid subscribers as of May 31, 1977, and, thus, the fair market value of those subscribers. As part of this determination, they each concluded that the only additional category of revenue which would be found in a paid subscription newspaper as compared to a free-distribution newspaper is the subscription revenue; similarly, the only additional category of costs is the cost of collecting that revenue. Mr. Berkey concluded that the aggregate fair market value of the paid subscribers of the Booth newspapers as of May 31, 1977, was $67,773,000, and Mr. Grabowski concluded that the fair market value was $60,470,000. The difference in these two valuation conclusions is attributable to Mr. Berkey's use of a four percent per annum inflation factor that Mr. Grabowski did not apply in this valuation. Mr. Berkey tested and confirmed his valuation conclusion by application of another income method under which the relevant portion of all revenues and costs, including editorial costs, production costs, and overhead, were allocated in the valuation of the paid subscribers as of May 31, 1977. Under that analysis, which Mr. Berkey explained was somewhat conservative, he concluded that the paid subscribers would be determined to have a value of $61,500,000, which supported his valuation conclusion under the preferred method of analysis.

As previously indicated, although the government contested the methodology utilized by plaintiff's experts, it offered no evidence to challenge the accuracy of the methodology utilized. Having concluded that the subscribers had no separate value, or if they did, that the cost of replacing the subscription list was the only appropriate method of analysis, no evidence was presented which would persuade the court that the opinions rendered by plaintiff's experts were inaccurate or invalid.

Based upon the explanation contained in Mr. Berkey's report of the reason why he utilized a four percent inflation factor, and the fact that the government did not challenge that part of Mr. Berkey's methodology and analysis, this court finds that the aggregate fair market value of the paid subscribers of the Booth newspapers as of May 31, 1977, was $67,773,000. The corresponding adjusted tax basis of those subscribers was $71,201,395. See Stip. para. i. The fair market value and adjusted tax basis for each newspaper was as follows:

Subscribers	Number of Subscribers	Fair Market Value	Adjusted Tax Basis
Ann Arbor News—Daily	37,743	3,966,000	4,166,626
Ann Arbor News—Sunday	37,122	557,000	585,177
Bay City Times—Daily	37,337	5,146,000	5,406,318
Bay City Times—Sunday	36,255	737,000	774,282
Flint Journal—Daily	91,366	14,392,000	15,120,040
Flint Journal—Sunday	91,155	1,810,000	1,901,561
Grand Rapids Press—Daily	120,011	13,250,000	13,920,270
Grand Rapids Press—Sunday	106,859	1,761,000	1,850,083
Jackson Citizen Patriot—Daily	35,711	4,622,000	4,855,811

Jackson Citizen Patriot—Sunday	35,632	688,000	722,803
Kalamazoo Gazette—Daily	51,481	6,655,000	6,991,653
Kalamazoo Gazette—Sunday	52,960	1,021,000	1,072,649
Muskegon Chronicle—Daily	41,203	5,116,000	5,374,800
Muskegon Chronicle—Sunday	40,609	651,000	683,932
Saginaw News—Daily	49,327	6,446,000	6,772,080
Saginaw News—Sunday	48,942	955,000	1,003,310
Total		$ 67,773,000	$ 71,201,395

Stip. para. i.

Morning Ledger is entitled to depreciate the adjusted tax bases of the paid subscribers of the Booth newspapers as of May 31, 1977, as determined by this Court, on a straight-line basis over their stipulated useful lives.

To the extent any conclusion of law is deemed to be a finding of fact, it is to that extent hereby made a finding of fact.

Conclusions of Law

This court has jurisdiction of this matter pursuant to 28 U.S.C. § 1346(a)(1). Venue is proper pursuant to 28 U.S.C. § 1402(a)(2).

This matter arises under section 167 of the Code, which provides, in part, that a taxpayer shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in its trade or business, or of property held by the taxpayer for the production of income. Also relevant is section 1.167(a)-3 of the Treasury regulations, 26 C.F.R. Sec. 1.167(a)-3 at 649 (1988), which provides in pertinent part:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. . . . No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

The standard set forth in section 1.167(a)-3 of the Treasury regulations has evolved into a two-pronged test. To depreciate an intangible asset, a taxpayer must demonstrate as a factual matter that the asset has: a limited useful life, the duration of which can be estimated with reasonable accuracy, and an ascertainable value separate and apart from goodwill. *See, e.g., Donrey, Inc. v. United States*, 809 F.2d 534, 537 (8th Cir. 1987); *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1250 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129, 94 S.Ct. 867, 38 L.Ed.2d 754 (1974); *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463, 479 (1988), *appeal docketed* No. 89-8159 (11th Cir. March 3, 1989); Rev. Rul. 74-456, 1974-2 C.B. 65, 66.

Goodwill is conclusively presumed, per se, not to be depreciable. *Marsh & McLennan v. Commissioner*, 420 F.2d 667, 668 (3rd Cir. 1969); *Winn Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 683 n. 8 (5th Cir. 1971); *Skilken v. Commissioner*, 420 F.2d 266, 268 (6th Cir. 1969); *Houston Chronicle Publishing Co. v. United States*, supra at 1247; *Am. South Bancorporation v. United States*, 681 F.Supp. 698, 712 (N.D.Ala. 1988).

As the parties have stipulated, the determination is plainly a factual one to be made, in this instance, by the Court. The parties have stipulated that the determination of whether intangible assets, including customer base as-

sets such as Booth's at-will relationships with the paid subscribers of its newspapers on May 31, 1977, have limited useful lives is a factual inquiry. *See, e.g., Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 452, 210 Ct. Cl. 431 (1976). In this regard, the Treasury regulations require only that the useful lives be estimated with "reasonable accuracy." Treas. Reg. § 1.167(a)-3. As the Fifth Circuit explained in *Houston Chronicle:* "Extreme exactitude in ascertaining the duration of an asset is a paradigm that the law does not demand. All that the law and regulations require is reasonable accuracy in forecasting the asset's useful life." 481 F.2d at 1253-54. *See also Burlington Northern, Inc. v. United States*, 676 F.2d 566, 573, 230 Ct. Cl. 102 (1982); *Richard S. Miller & Sons, Inc.*, 537 F.2d at 455; *Citizens & Southern Corp.*, 91 T.C. at 500; *Liquid Paper Corp. v. United States*, 83-1 U.S.T.C. para. 9305 at 86,779, 2 Cl. Ct. 284 (1983); *Business Service Indus., Inc. v. Commissioner of Internal Revenue*, 51 T.C.M. 539, 543 (1986).

The fair market value of an asset is the price at which the asset would change hands between a hypothetical willing buyer and willing seller, neither being under any compulsion to buy or sell, both parties having reasonable knowledge of relevant facts. Rev. Rul. 59-60, 1959-1 C.B. 237.

Conclusion

Morning Ledger is entitled to depreciate the value of the paid subscribers of the Booth newspapers acquired on May 31, 1977, over their stipulated useful lives, having established that the subscribers have limited useful lives that can be estimated with reasonable accuracy and an ascertainable value separate and apart from goodwill.

To the extent any finding of fact is deemed to be a conclusion of law, it is to that extent hereby made a conclusion of law.

As part of and consistent with these Findings of Fact and Conclusions of Law and any Final Order entered in this matter, the parties are directed to calculate the actual amounts of tax and interest due to Morning Ledger consistent with the Court's findings and opinion.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

NO. 90-5637

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY,
Appellee

v.

THE UNITED STATES OF AMERICA,
Appellant

(D.C. Civ. No. 88-04836)

SUR PETITION FOR PANEL REHEARING
WITH SUGGESTION FOR REHEARING IN BANC

PRESENT: SLOVITER, *Chief Judge*, BECKER, STAPLETON, MANSMANN, GREENBERG, HUTCHINSON, SCIRICA, COWEN, NYGAARD, ALITO, and ROTH, *Circuit Judges* and SMITH, *District Judge*•

The petition for rehearing filed by appellee, having been submitted to the judges who participated in the decision of this Court and to all the other available circuit judges in active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is DENIED.

• Honorable D. Brooks Smith, United States District Judge for the Western District of Pennsylvania, sitting by designation.

Judge Greenberg and Judge Nygaard would have granted rehearing.

BY THE COURT:

/s/ Ernest R. Becker
Circuit Judge

DATED: OCT 15 1991

FILED
MAR 16 1992
OFFICE OF THE CLERK

No. 91-1135

In the Supreme Court of the United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether the purchaser of a newspaper business may treat the future revenues that it anticipates receiving from the continuing patronage of existing customers as an "intangible asset" that is depreciable under Section 167 of the Internal Revenue Code, 26 U.S.C. 167.

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Statutes and regulations:

Internal Revenue Code (26 U.S.C.):

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Miscellaneous:

B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* (5th ed. 1987) 2

United States General Accounting Office, *GAO/GGD-91-88 Tax Policy Report* (1991) 15

In the Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-1135

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-30a) is reported at 945 F.2d 555. The opinion of the district court (Pet. App. 31a-51a) is reported at 734 F.Supp. 176.

JURISDICTION

The judgment of the court of appeals was entered on September 12, 1991. A petition for rehearing with suggestion for rehearing en banc was denied on October 15, 1991 (Pet. App. 52a-53a). The petition for a writ of certiorari was filed on January 13, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1976, petitioner's predecessor, the Herald Company, purchased all the stock of Booth Newspapers, Inc. Booth was the publisher of eight newspapers distributed in various Michigan communities. In 1977, Herald liquidated Booth and received all of its assets, including the eight newspaper operations. At the time of Booth's liquidation, these eight newspapers collectively had 460,000 regular subscribers.[1] Herald continued publication of the newspapers under their former banners after Booth was liquidated (Pet. 3a-4a, 34a-35a).

Following the liquidation of Booth, under the provisions of what was then Section 334(b)(2) of the Internal Revenue Code, Herald was required to allocate its basis in the Booth stock (approximately $328 million) among the assets that it received from Booth's liquidation.[2] In making this allocation, Herald was required to assign basis first to the cash, cash equivalents and marketable securities that it received from Booth, then to Booth's tangible and intangible assets (at their fair market values), with the remainder to be allocated to "goodwill" (Pet. App. 36a). See Treas. Reg. § 1.334-1(c)(4); *R.M. Smith, Inc.* v. *Commissioner*, 591 F.2d 248 (3d Cir. 1979).

Herald allocated approximately $234 million of its basis in the Booth stock to cash, securities and tangible assets such as the land, buildings and equipment formerly owned by Booth (Pet. App. 36a). Herald then assigned approximately $68 million to an intangible asset that it described as "paid subscribers" (*id.* at 4a). This "intangible asset" represented simply the number of ordinary customers who, at the time of Booth's liquidation, subscribed on a daily, at-will basis to one of the Booth newspapers (*id.* at 12a). See note 1, *supra*. Herald assigned a value of $68 million to this "intangible asset" under the following rationale: (i) due to factors such as death, relocation, and the mutable nature of consumer preferences, the average person who subscribed to Booth's newspapers on the date of Booth's liquidation would be expected to continue to purchase those newspapers for only a limited number of years, which Herald's experts estimated would vary from 14 to 23 years within the particular communities involved (*id.* at 39a); (ii) during those average lengths of continued consumer patronage, the newspapers would receive cumulative revenues from those pre-existing subscribers, net of the costs of collection, equal to the present

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[1] Petitioner repeatedly refers to these subscribers as "paid subscribers" (Pet. 4, 6, 7, 8, 9, 10, 15, 16, 26). Any connotation that these subscribers had "paid" for their subscriptions in advance is incorrect. To the contrary, these were merely daily, at-will subscriptions subject to cancellation without notice or obligation (Pet. App. 12a). Petitioner had no contractual or other legal rights to insist upon any future performance, or to demand any future custom, from any of its so-called "paid subscribers" (*ibid.*). Because the term "paid subscribers" is misdescriptive, we have substituted the term "subscribers" for it in this brief.

[2] Section 334(b)(2), 26 U.S.C. 334(b)(2) (1976), was repealed by Congress in 1982 and replaced by the somewhat different provisions of Section 338. See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 11.46, at 11-62 (5th ed. 1987). A taxpayer may also obtain all of the assets of a target corporation simply by purchasing them directly. In that situation, the taxpayer is also required to allocate the total purchase price among the acquired assets in accordance with their fair market value. See, *e.g.*, *F. & D. Rentals, Inc.* v. *Commissioner*, 365 F.2d 34 (7th Cir. 1966); *Copperhead Coal Co.* v. *Commissioner*, 272 F.2d 45 (6th Cir. 1959).

value sum of $68 million (*id.* at 44a, 46a-47a).[3] Although these customers were free to discontinue their patronage of the newspapers at any time (see note 1, *supra*), Herald's valuation rested on the assumption that they would remain customers, and produce revenues for the newspapers, for an average of 14 to 23 years after ownership of the newspapers changed hands. After allocating $68 million of its basis in the Booth stock to the "intangible asset" of its non-contractual relationships with its existing customers, Herald allocated the balance of the purchase price that remained ($26 million) to "goodwill" (Pet. App. 4a).

2. Section 167(a) of the Internal Revenue Code authorizes, as a deduction for depreciation, "a reasonable allowance for the exhaustion, wear and tear * * * of property used in the trade or business." 26 U.S.C. 167(a). On its income tax returns for periods following the liquidation of Booth, Herald sought to deduct a depreciation allowance for the "intangible asset" it claimed existed in its relationships with its at-will customers. Herald claimed that this "asset" (valued at $68 million) represented "property used in [its] trade or business" (26 U.S.C. 167(a)) that should be depreciated on a straight-line basis over the expected life of those customers' patronage (Pet. App. 4a).

[3] In making this calculation, Herald did not reduce the subscription revenues by the costs that it would necessarily incur in producing and delivering the newspaper to its customers (Pet. App. 44a). The only costs deducted by Herald in determining the expected value of its existing relationship with its subscribers were the limited costs involved in collecting the subscription revenues (*ibid.*). The government offered evidence establishing that the cost of developing the number of subscribers claimed by the Booth newspapers was approximately $3 million (*id.* at 29a).

The Internal Revenue Service disallowed the claimed depreciation deductions. Since 1927, Treasury Regulations under Section 167 have consistently provided that "[n]o deduction for depreciation is allowable with respect to goodwill." Treas. Reg. § 1.167(a)-3.[4] In the Service's view, the so-called intangible asset of "paid subscribers" (see note 1, *supra*) represents nothing other than the expected income from future patronage of present customers, which is the "goodwill" of the business that Herald purchased from Booth. The Service therefore concluded that Herald was not entitled to a deduction under Section 167.

Herald paid the additional income taxes resulting from disallowance of its claimed deduction for depreciation of its subscribers. When Herald was acquired by and merged into petitioner, petitioner filed administrative claims for refund of the additional taxes that Herald had paid. The Internal Revenue Service did not grant the requested refunds, and petitioner brought this suit in district court (Pet. App. 4a-5a, 33a-35a).

3. Following a bench trial, the district court held in petitioner's favor, ruling that the claimed depre-

[4] Treas. Reg. § 1.167(a)-3 provides:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

ciation deductions were allowable in full (Pet. App. 31a-51a). The court acknowledged that "[g]oodwill is conclusively presumed, per se, not to be depreciable" (*id.* at 49a) and that the so-called "paid subscribers" would qualify as a depreciable asset only if they were shown to have (1) a "limited useful life" whose duration could be estimated with reasonable accuracy and (2) "an ascertainable value separate and apart from goodwill" (*ibid.*).

Without considering the threshold question whether the at-will relationship between petitioner and its subscribers was "property used in the trade or business" (26 U.S.C. 167(a)) for which a depreciation deduction *could* be claimed under Section 167, the court was satisfied that petitioner had established that these subscriber relationships had a limited useful life to the business. In reaching this conclusion, the court relied on petitioner's statistical evidence that the subscribers who existed at the time of liquidation would, over a period of years, cease to be subscribers due to death, relocation, loss of interest in the newspapers, or other causes (Pet. App. 40a-42a). Although it was not disputed that the total number of petitioner's subscribers had actually increased during the years in question (*id.* at 40a), in the court's view, it was "not relevant" that new customers replaced old ones, keeping the newspapers' circulation base intact (*ibid.*).

The district court also concluded that the subscriber relationships had an ascertainable value to the newspaper company of approximately $68 million. That figure was calculated, under the methodology applied by petitioner, by capitalizing the stream of subscription income anticipated from the 460,000

existing subscribers over the average expected duration of their future patronage (Pet. App. 42a-48a).[5]

The district court further concluded that the $68 million attributed to this continuing patronage represented an asset separate and apart from goodwill (Pet. App. 32a-33a, 45a-48a). The court acknowledged that goodwill is the non-contractual expectation that "former customers will be retained—that there will be continued patronage" (*id.* at 32a, 45a). This is often described as "the expectancy that the old customers will resort to the old place" (*ibid.*). In the court's view, however, a business enjoys goodwill only when it has "a galaxy" of anonymous customers "who may or may not return" and whose "future purchases cannot be predicted" (*id.* at 32a). The court stated that the subscribers involved in this case had value and longevity as customers that "can be measured with a fair degree of accuracy" and thus possessed "unique characteristics" separating them from "general goodwill" (*id.* at 45a). The court therefore concluded that petitioner satisfied both elements of the "two-prong test" for depreciability and upheld petitioner's refund claims (*id.* at 49a).

4. The court of appeals reversed (Pet. App. 1a-30a). The court rejected petitioner's contention that any element of a business that is shown to have a limited useful life is, for that reason alone, distinct from goodwill (*id.* at 12a & n.6). The court noted that it has long been settled that goodwill, which represents the expectancy of continued patronage from existing customers, may not be depreciated (*id.* at

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[5] In calculating the net income from subscriptions for this purpose, the only costs taken into account were the relatively nominal ones of billing and collecting the subscription fees. The major costs of publishing and distributing the newspapers were omitted (Pet. App. 44a-45a).

23a-25a). The court regarded it as implicit within the numerous decisions concerning goodwill (and explicit in some of them) that the non-contractual expectancy of future patronage may not be written off as an amortizable asset even if it has a limited useful life due to the normal consumer attrition that results from death, relocation, changing tastes, and similar commercial factors (*id.* at 25a-27a, 29a).[6] The court further noted that this conclusion has long been embedded in Treasury Regulations that Congress has not disturbed (*id.* at 28a) and expressed reluctance "to announce a sudden redefinition of a concept so fundamental to tax accounting" (*ibid.*).

The court of appeals concluded that the value that petitioner imputed to its existing subscriber relationships "inherently includes much or all of the value of the expectancy that those customers will continue their patronage" and "is quite clearly comprised largely, if not exclusively, of amounts properly attributable to goodwill" (Pet. App. 30a). Finding that petitioner therefore failed to carry the burden of establishing "a value for its so-called subscribers that

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[6] The court of appeals correctly observed that this case does not involve "contractually-based" rights (Pet. App. 11a) that properly would be amortizable under Section 167 (Pet. App. 11a-12a):

> [I]f the subscribers were contractually obligated to continue subscribing for some period of time, [petitioner] clearly would be permitted to depreciate the value of those contracts over that time period. In such an event, continued patronage would not be a mere "expectation," but a contractual right, and hence not goodwill. In the case at bar, however, all the subscribers are *terminable-at-will*. At the time of the acquisition of Booth, therefore, Herald merely expected continued patronage; it had no contractual right to demand it.

is separate and distinct from goodwill," the court disallowed petitioner's claimed depreciation deductions (*ibid.*).

The court acknowledged (Pet. App. 18a-23a) that *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987) (allowing amortization of newspaper "subscription lists"), and *Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463 (1988), aff'd per curiam, 919 F.2d 1492 (11th Cir. 1990) (allowing amortization of a bank's "core deposits"), seemingly permit taxpayers to amortize "intangible assets" whose value is based on the expected future patronage of existing non-contractual customers. The court concluded, however, that those decisions represent "no more than a minority strand amid the phalanx of cases that have considered the definition and application of the term 'goodwill' in the context of [Treas. Reg.] § 1.167(a)-3" (Pet. App. 23a).

DISCUSSION

The court of appeals correctly held that the value attributed by petitioner to the expected future patronage of its existing non-contractual customers is nondepreciable goodwill. We agree with petitioner, however, that this case involves a recurring issue of substantial administrative importance that has given rise to inconsistent reasoning and inconsistent decisions among the circuits. We therefore do not oppose the granting of certiorari in this case.

1. The prohibition against depreciation of goodwill was first included in Treasury regulations in 1927. See T.D. 4055, VI-2 C.B. 63, amending Art. 163 of Treas. Reg. 69 (Revenue Act of 1926). It has been carried forward essentially unchanged through repeated reenactments of the revenue laws and has now "acquired the force of law" (*Cammarano* v.

United States, 358 U.S. 498, 508-511 (1959)). See *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938). The basic characteristic of goodwill is the advantage that the proprietor of a business enjoys from the likelihood that existing customers will continue their patronage. *E.g.*, *Marsh & McLennan, Inc.* v. *Commissioner*, 420 F.2d 667, 669-670 (3d Cir. 1969). Goodwill may be attributable to a business's location, its age, the superiority of its products or services and any other factor that blesses it with a favorable name and reputation, helping to attract "constant or habitual customers" (*Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436, 446 (1893)).

The court of appeals correctly concluded that the $68 million that petitioner assigned as the value of its subscriber relationships represents nondepreciable goodwill. The subscribers were customers of the Booth newspapers when Herald took over their publication. The $68 million reflects petitioner's estimate of the income to be realized from the continuing patronage of those subscribers. The income to be derived in the future from the continuing patronage of customers falls precisely within the core of the concept of goodwill (Pet. App. 23a-25a). The value of this income is therefore not subject to depreciation under the express terms of the agency's longstanding regulations. Treas. Reg. § 1.167(a)-3.

The court of appeals correctly rejected petitioner's argument (Pet. 22-26) that the subscribers necessarily are a "property used in the trade or business" (26 U.S.C. 167(a)) that is separate from goodwill because the subscriber relationships have determinable useful lives due to death, relocation, loss of interest, or attrition for other reasons. The same is true, and could be estimated by statistical experts,

for the customers of any establishment.[7] But the very attributes of the Booth newspapers that attracted its subscribers may well induce new customers to replace them, with the result that the circulation base of the newspapers remains largely constant or even increases, as occurred in the present case (Pet. App. 40a). This ordinary turnover among clientele is one of the standard characteristics of the concept of goodwill. The value that petitioner attaches to its subscribers is directly subsumed within that concept.

2. a. Although the cases addressing the depreciation of intangibles are largely fact-based, we agree with petitioner (Pet. 15-16) that the decision in *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987), could be said to conflict with the decision in the present case.[8] In *Donrey*, the taxpayer bought a

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[7] For example, an expert could no doubt be found to conclude that some specific percentage of a particular grocery store's customers are "regular customers" who shop at that store each week and will, for some estimated average length of time, continue to do so in the future until their patronage is lost due to death, relocation or changing consumer preferences. The analysis employed by petitioner in this case thus could be used to convert the goodwill of almost any commercial establishment into a depreciable "intangible asset."

[8] Petitioner clearly errs, however, in contending (Pet. 13) that the decision in the present case conflicts with *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974). As the court of appeals correctly stated in its opinion in this case (Pet. App. 17a):

> The *Houston Chronicle* did not purchase an ongoing business or even a tradename as did Morning Ledger, but rather the idle assets of the defunct *Houston Press*. Hence, there was no "expectancy that old customers would resort to the old place" because "the old place" no longer existed. The value of the customer list to the *Houston Chronicle*

newspaper business for $1.3 million. Like Herald, the taxpayer in *Donrey* "stepped into the shoes" of the former owner by continuing to publish the paper under the same name. The taxpayer sought to depreciate a written subscription list (showing the number, names and addresses of subscribers) that it obtained during the purchase of the newspaper as an "intangible asset" having a limited useful life and a value of $560,000 apart from goodwill. It calculated that figure as "the present value of the difference in advertising revenues generated by the subscription list as compared to the revenues of an equivalent paper without a subscription list." *Id.* at 536. "This value was thus characterized as being separate and apart from goodwill." *Ibid.* In affirming the jury verdict in favor of the taxpayer, the court of appeals concluded that the question whether the subscription list was an asset with a limited life that was separate from goodwill was one of fact for the jury. *Id.* at 536-537.

The issue addressed in *Donrey* is factually distinct from the issue addressed in the present case. In *Donrey*, the taxpayer made an effort to identify its written "subscription list" as an asset separate and apart from its continuing non-contractual relationship with its subscribers. The taxpayer's conceptual distinction was emphasized by the method of valuation that was employed in *Donrey*: instead of simply calculating the future *sales revenues* to be derived from the continuing patronage of its existing non-

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therefore lay solely in its potential use as a marketing tool to solicit *new* customers to a *new* business.

* * * *Houston Chronicle* presented the paradigmatic circumstances under which a taxpayer could demonstrate that a subscriber list is "separate and distinct from goodwill."

contractual subscribers (as the taxpayer did in the present case), the taxpayer in *Donrey* calculated the additional future advertising revenues that it hoped to obtain by showing its subscription list to potential advertisers. See 809 F.2d at 536.

While we disagree with the conclusion in *Donrey* that this indirect benefit of continuing patronage is distinct from the value of goodwill,[9] it is nonetheless possible to distinguish the *Donrey* decision from the present case on that basis. The court of appeals concluded in this case, however, that, while the decision in *Donrey* was "cursory" and premised on deference to jury findings of fact (Pet. App. 18a), the reasoning and conclusion of *Donrey* are "directly in conflict" (*id.* at 19a) with the present case.

b. The analysis applied by the Eleventh Circuit in *Citizens & Southern Corp.* v. *Commissioner*, 919 F.2d 1492 (1990), aff'g per curiam 91 T.C. 463 (1988), and by the Tax Court in *Colorado National Bancshares, Inc.* v. *Commissioner*, 60 T.C.M. (CCH) 771 (1990), conflicts with the decision in this case. The question in *Citizens & Southern Corp.* was whether the buyer of a bank may amortize the value of the bank's "core deposits," a term defined by the taxpayer to refer to the funds that the bank's customers had on deposit at relatively low rates of interest at the time ownership of the bank changed

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[9] As the district court stated in *General Television, Inc.* v. *United States*, 449 F. Supp. 609 (D. Minn. 1977), aff'd per curiam, 598 F.2d 1148 (8th Cir. 1979), "in the instances in which customer or subscriber lists have been determined to have an ascertainable value separate and apart from goodwill, the lists alone carried with them no expectancy of continued patronage." 449 F. Supp. at 611-612. See also *Panichi* v. *United States*, 834 F.2d 300, 301-302 (2d Cir. 1987) (customer list depreciable when not acquired as part of a going concern).

hands. Such "core deposit" funds provided a significant source of the bank's income because the bank used them to make loans at higher rates of interest. The Commissioner argued that this "core deposit" intangible represented simply the value associated by the bank with the expectation that existing customers would continue their patronage by leaving funds on deposit with the bank for a number of years. The Tax Court, however, permitted the buyer to amortize the value of its "core deposits" as a wasting asset. 91 T.C. at 505-512.[10] The Eleventh Circuit affirmed and adopted the Tax Court's opinion. 919 F.2d at 1492.

In the present case, the Third Circuit disagreed with the reasoning and result of *Citizens & Southern Corp.* and found the rationale of *AmSouth Bancorporation & Subsidiaries* v. *United States*, 681 F. Supp. 698 (N.D. Ala. 1988), to be a more "persuasive and well-articulated" (Pet. App. 27a) analysis of the depreciability of customer-related intangibles such as "core deposits" (681 F. Supp. at 720):

> For accounting purposes, a bank may be able to "identify" a customer deposit base even though it may not be separate and distinct from goodwill. To the extent that deposits remain after some contractually stipulated period, they result from "continued patronage." The mere fact that the deposits themselves are identifiable, does not make their "*value*" separate and distinct from goodwill. Other facets of bank activities such as safe deposit "expectations," loan "expectations," etc. could perhaps be similarly

[10] The Tax Court reached a similar conclusion in *Colorado Nat'l Bancshares, Inc.* v. *Commissioner*, 60 T.C.M. (CCH) 771 (1990).

> "identified" so as to phase out the concept of goodwill.

The court of appeals in the present case therefore declined to follow the reasoning of the Eleventh Circuit in *Citizens & Southern Corp.* (Pet. App. 26a-27a).

3. The question presented in this case is of considerable administrative importance and potentially affects many taxpayers (see note 7, *supra*). The long-standing prohibition against the amortization of goodwill has been the subject of a substantial volume of litigation in the past and present. The revenue stakes are often high; they exceed $10 million in this case alone. A taxpayer who purchases and continues to operate a business that is favorably positioned in its market ordinarily pays a "premium" over and above what the tangible assets of the business would be worth if bought individually. This premium associated with the going concern value or goodwill of the business is often quite large. Purchasers who have paid such substantial premiums for the goodwill of a business have often argued that customer lists, subscription lists, insurance expirations, and similar items can be carved out as property independent of goodwill, assigned a discrete value and useful life, and amortized over some specific term of years. See Pet. App. 23a-25a (citing cases).

The United States General Accounting Office reports that the Internal Revenue Service, as of 1989, had proposed more than $4 billion of adjustments in cases involving the depreciation of customer or market-based intangible assets. United States General Accounting Office, *GAO/GGD-91-88 Tax Policy Report* 4 (1991). The Internal Revenue Service advises us that additional large adjustments have been

proposed in subsequent periods for tax returns claiming depreciation deductions for customer-based intangible assets. Because the courts of appeals have employed inconsistent rationales for analysis of these deductions, resolution of this recurring conflict is needed to avoid continuing uncertainty and uneven application of the revenue laws.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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IN THE
Supreme Court of the United States
October Term, 1991

NEWARK MORNING LEDGER CO.,
as successor to the Herald Company,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court of Appeals for the Third Circuit

JOINT BRIEF OF AMICI CURIAE PENNSYLVANIA PETROLEUM ASSOCIATION AND FUEL MERCHANTS ASSOCIATION OF NEW JERSEY IN SUPPORT OF PETITION

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IN THE
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---

JOINT BRIEF OF AMICI CURIAE PENNSYLVANIA PETROLEUM ASSOCIATION AND FUEL MERCHANTS ASSOCIATION OF NEW JERSEY IN SUPPORT OF PETITION

This brief is submitted in support of Appellant Newark Morning Ledger Co's. Petition for a Writ of Certiorari to review the Third Circuit Court of Appeals decision (945 F.2d 555 (3rd Cir. 1991)) reversing the decision of the United States District Court for the District of New Jersey (734 F.Supp. 176 (D.N.J. 1990)) in favor of Appellant.

INTERESTS OF AMICI CURIAE*

The opinion of the Third Circuit Court of Appeals presents issues of major significance to petroleum jobbers and dealers within the jurisdiction of the Third Circuit.

The Pennsylvania Petroleum Association ("PPA") and the Fuel Merchants Association of New Jersey ("FMANJ") are both regional trade associations whose active members are not producers, refiners or manufacturers of petroleum products, but independent business entities each employing an average of more than 10 persons. PPA has 580 active members and 333 associate members and FMANJ has 480 active members. All of the members of FMANJ and most of the active members of PPA are engaged in the sale of home heating oil to residential consumers.

In almost every case the Customer List of a retail fuel oil dealer is its single most valuable asset. For the past twenty years it has been universally recognized that the purchaser of such a Customer List could amortize its value over its useful life - the issues of value and useful life being factual issues dependent on the particular facts and circumstances of each transaction. The decision of the Third Circuit in the instant case disregards almost twenty years of judicial precedent as well as the stated position of the Internal Revenue Service as set forth in Rev. Rule 74-456.

The Circuit Court's decision raises the spectre that depreciation deductions heretofore allowed for two decades to purchasers of retail fuel oil customer lists and similar intangible assets acquired in the purchase of a going concern may be denied *as a matter of law* thus eliminating the facts and circumstances test established by both judicial precedent and the Internal Revenue Service's

*Written consents as required by Rule 37 of the Supreme Court Rules for the filing of this brief were obtained and are on file in the Clerk's office. The decision below is reported at 945 F.2d 555.

own regulations and rulings. The effect will be devastating to the petroleum dealers represented by PPA and FMANJ as it will result in a substantial decrease in the value of each member's Customer List by reason of the fact that a purchaser may no longer be permitted to deduct the cost of acquiring the same. The tax Reform Act of 1986 has already dealt a servere blow to sellers of a retail fuel oil business (as well as other small businesses) by eliminating the "General Utilities" doctrine formerly embodied in I.R.C. §337 thus subjecting them to a double tax - at both the corporate and shareholder levels whereas the former tax could previously have been provided by compliance with I.R.C. §337.

If this decision is permitted to stand, the small businesses which comprise the active membership of PPA and FMANJ may be rendered virtually unsaleable with the result that the substantial tax revenues currently generated by such transactions may evaporate.

ARGUMENT

I

THE THIRD CIRCUIT'S DECISION DISREGARDS ALMOST TWENTY YEARS OF JUDICIAL PRECEDENT AS WELL AS THE INTERNAL REVENUE SERVICE'S OWN INTERPRETATION REGARDING DEPRECIATION OF INTANGIBLE ASSSETS AND REQUIRES REVIEW BY THIS COURT.

In addition to those reasons for granting ceriorari set forth in Newark Morning Ledger Co's. Petition, which are hereby adopted, the Third Circuit's opinion is, as a practical matter, a reincarnation of the "Mass Asset" rule which was interred in *Houston Chronicle Publishing Co. v. U.S.*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

Prior to 1974 the Internal Revenue Service took the position that intangible assets in the nature of customer lists were not depreciable and the majority of the court decisions prior to 1970 favored the government, although the courts generally characterized the issue as factual, not legal. *Thrifticheck Service Corporation v. Commissioner*, 287 F.2d 1 (2d Cir. 1961); *Klein v. Commissioner*, 372 F. 2d 161 (2d Cir. 1966).

However, starting with the decision of the Ninth Circuit Court of Appeals in *Commissioner v. Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966), the courts, and later the Internal Revenue Service, began to recognize that in the context of modern business "...when lists are bartered and sold as discrete vendible assets",[1] amortizability of intangible assets is a factual question to be determined in each case and further liberalized the evidentiary burden on the taxpayers required to sustain the deduction. See also *Manahattan Company of Virginia*, 50 T.C.78 (1968); Gov't's appeal to CA-4 dismissed (nolle pros.), 12/9/68; Gov't's appeal to CA-DC dismissed (nolle pros.) 1/27/69.

Houston Chronicle Publishing Co. v. U.S., 481 F. 2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) involved newspaper subscription lists purchased by Houston Chronicle from a competitor which was ceasing business. No allocation of the total purchase price was made prior to the closing of the transaction which also involved the acquisition of the printing plant, equipment, inventory and other tangible assets of the competitor as well as a 10 year covenant not to compete. After the sale, the taxpayer engaged an appraiser to evalute the acquired assets and the subscription list was valued at $71,200.

The Court upheld the deduction emphasizing that the

1. *Houston Chronicle Publishing Co. v. U.S.*, 485 F2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974).

question of amoritizability is exclusively an issue of fact, stating as follows:

> "Judicial tolerance compels us to say that many jurists and scholars could diagnose tax non-depreciability in the muscles and tendons of list transactions. We reject, however, the establishment of a per se rule and a monolithic "mass asset" theory that would amalgamate all subscriptions lists with goodwill.
>
> "Our view -- that amortizability for tax purposes must turn on factual bases -- is more in accord with the realities of modern business technology in a day when lists are bartered and sold as discrete vendible assets. Extreme exactitude in ascertaining the duration of an asset is a paradigm that the law does not demand. All that the law and regulations require is reasonable accuracy in forecasting the asset's useful life." (481 F.2d at pp 1253-4)

In arriving at its conclusion, the Court's opinion distinguishes the earlier "goodwill" and "mass asset" cases (including *Klein, supra; Thrifticheck Service Corporation v. Commissioner, supra;* and *Anchor Cleaning Service, Inc. v. Commissioner*, 22 T.C. 1029 (1954) as involving evidentiary failure on the part of the taxpayer.

The opinion acknowledges that no depreciation deduction is allowable with respect to an intangible asset such as goodwill which does not have a limited useful life and further recognizes that the "only question litigated in recent years ... is whether a particular asset is 'goodwill' ". The Court then reviewed the definition of "goodwill" for tax purposes as follows:

" '(T)he nature of goodwill...is the expectancy that 'the old customers will resort to the old place.'...

" 'This Court has held that...goodwill is acquired by the purchaser of a going concern where the 'transfer enables the purchaser to step into the shoes of the seller.' We have also said that goodwill is transferred where, as here, the buyer continues the seller's business uninterrupted, using primarily the seller's employees, and utilizing the seller's name." [citations omitted] (Emphasis supplied) (481 F.2d at p. 1247).

The Court also recognized that the threshold question in determining the amortizability of a customer list (or any intangible asset) is whether that asset can be shown to have a limited useful life in the purchaser's business. If a limited useful life is established, then the asset cannot be goodwill which, by definition, continues indefinitely.

In 1974, in response to the taxpayer victories in the foregoing cases and others (including *Holden Fuel Oil Co. v. Commissioner*, 479 F.2d 613 (6th Cir. 1973), discussed infra) the Internal Revenue Service conceded in Rev. Rul. 74-456, 1974-2 C.B. 65, that customer lists, insurance expirations and similar intangible assets are not, as a matter of law, indistinguishable from goodwill; rather the question of amortizability is recognized to be a factual question. Rev. Rul. 74-456 reads in part:

"Generally, customer and subscription lists, location contracts, insurance expirations, etc., represent the customer structure of a business, their value lasting until an indeterminate time in the future. These lists, contracts, insurance expirations, etc., are in the nature of goodwill or otherwise, have indeterminable lives and, therefore, are not subject to depreciation. [citations omitted]

"However, if in an unusual case the asset or a portion thereof does not possess the characteristics of goodwill, is susceptible of valuation, and is of use to the taxpayer in its trade or business for only a limited period of time, a depreciation deduction is allowable. See Manhattan Company of Virginia, 50 T.C. 78 (1968) acq., page 3, in which the court determined that the trial record contained sufficient facts to permit an allocation of the purchase price of customer lists between depreciable and nondepreciable portions.

"*Rev. Rul. 65-175 and Rev. Rul. 65-180 are modified to remove any implication that customer and subscription lists, location contracts, insurance expirations, etc., are, as a matter of law, indistinguishable from goodwill possessing no determinable useful life. The depreciability of assets of this nature is a factual question, the determination of which rests on whether the taxpayer establishes that the assets (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy.* No deduction is allowable merely because a basis has been estimated and the asset has a limited useful life in the unsupported view of the taxpayer. See Houston Chronicle Publishing Co. v. United States, 73-2 U.S.T.C. 81,697 (5th Cir. 1973); Skilken v. Commissioner, 420 F.2d 266 (6th Cir. 1969) (Emphasis supplied)

Since 1974 and until the Third Circuit decision in this case the Courts have been surprisingly consistent in upholding amortization deductions under I.R.C. § 167(a) for intangi-

ble assets in the nature of customer lists. See *Richard S. Miller & Sons, Inc. v. U.S.*, 557 F.2d 446 (Ct. Cls. 1976); *L.A. Central Animal Hospital, Inc. v. Commissioner*, 68 T.C. 269 (1977) (upholding amortization of Customer List despite (i) purchase of business as a "going concern"; (ii) continued use of Seller's name; and (iii) continued use of Seller's business location); *Panichi v. United States*, 834 F.2d 300 (2nd Cir. 1987); *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987); *McCarthy v. United States*, 807 F.2d 1306 (6th Cir. 1986); *Ralph W. Fullerton Co. v. United States*, 550 F.2d 548 (9th Cir. 1977); *Citizens and Southern Corporation and Subsidiaries v. Commissioner*, 91 T.C. 463 (1988), aff'd per curiam, 900 F.2d 266 (11th Cir. 1990).

From an examination of these cases, Rev. Rul 74-456 and Regs. § 1.167(a)-3, it is clear that (i) a Customer List is not, as a matter of law, indistinguishable from goodwill; (ii) the question of amortizability is a factual issue; and (iii) a Customer List may be amortized if the taxpayer establishes that the asset has (a) a limited useful life, the duration of which can be ascertained with reasonable accuracy, and (b) an ascertainable value separate and apart from goodwill. Once it has been established that such an asset has a limited useful life, it cannot be equated with goodwill which, by definition, continues indefinitely.

II

UNLESS REMEDIED BY THIS COURT, THE THIRD CIRCUIT'S DECISION WILL HAVE A SIGNIFICANT ADVERSE EFFECT ON THE VALUE OF A FUEL OIL CUSTOMER LIST.

As stated above, the single most valuable asset of a retail fuel oil dealer is its Customer List which the decided

cases have consistently held to be depreciable wasting assets.

In *Holden Fuel Oil Company v. Commissioner*, 479 F. 2d 613 (6th Cir. 1973), the Court of Appeals upheld the amortizability of a retail fuel oil Customer List. After stating the obvious - that the cost of an intangible asset may be amortized if it can be established "that the asset is of use in a business for only a limited period of time which can be estimated with reasonable accuracy," the Court firmly rejected the government's contention that the lists were intangible assets in the nature of goodwill.

> "The appellant's first contention is that the lists are not amortizable because they are intangible assets in the nature of goodwill, and have no reasonably ascertainable useful lives. The appellant argues that the purchaser obtains not only a list of names, but also obtains an established clientele and an ongoing business relationship, the value of which fluctuates as customers are dropped or acquired, and that therefore, the lists have a business usefulness of a limited time which is not reasonably ascertainable.
>
> "We disagree. The appellee's only guaranteed acquisition from this contractual arrangement was the list of names. Although Gulf did send a form letter to all of the customers on the list informing them that the appellee was now distributing Gulf Oil in the area and solicited their business, these customers were not obligated to purchase fuel oil from the appellee because there had been no contract between Gulf and its customers. The list contained over 5,000 potential customers, but only 3,007 accounts were sold fuel oil by the appellee during the fiscal year ended May 31, 1962. On May 31, 1968, only 1,577 customers were still purchasing oil from the appellee.

"*Since the appellee initially acquired a list of 5,199 names, and was supplying only 1,577 of them with oil as of May 31, 1968, the lists were demonstrably wasting assets. Furthermore, evidence was introduced to show that the appellee would lose approximately 10% of its customers each year.* Trade indicators calculated the life of a fuel oil account to be from 8 to 10 years. Furthermore, the parties stipulated that the appellee lost approximately 50% of its total fuel oil deliveries initially acquired from the list in a six year period following May 31, 1962, the year that the contract price was determined. Upon this evidence, the Tax Court determined that the list acquired by the appellee had a limited life and that life was reasonably ascertainable. This was in accordance with the regulations which provide that an intangible asset may be the subject of a depreciation allowance if it is known from experience or other factors to be of use in the business for only a limited period, the length of which can be estimated with reasonable accuracy. Treas. Reg.§ 1.167(a)-3" (Emphasis supplied).

The recent case of *ABCO Oil Corp. v. Commissioner*, 46 T.C.M. (CCH) 343 (1990) involved the issue of whether the purchaser of two retail fuel oil operations in Pennsylvania could depreciate the costs attributable to the Customer Lists acquired together with other assets, including "Goodwill." In upholding the depreciation deduction, the Court stated that:

"A customer list is an intangible asset which may be amortized if it has a useful business life of limited duration, the length of which can be estimated with reasonable accuracy. Goodwill, on the other hand, does not have a limited useful business life and thus is not amortizable. § 1.167(a)-3, Income Tax Regs....

"The determination as to whether a customer list has value independent of good will and if so, the amount of that value, is a question of fact. The record herein clearly supports a finding, and we so find, that both the Panczak and Flad customer lists have independent value. Indeed, respondent's expert conceded such on the stand....

"...[W]e believe petitioner, to a limited extent, desired to preserve Panczak and Flad customer continuity. It would be naive for us to believe that petitioner did not attempt to preserve the patronage of the former customers of Panczak and Flad when it notified the former customers of Panczak and Flad that it had acquired the latter's businesses and when it kept the Panczak and Flad phone numbers and listed them in the phone book. These actions obviously were taken to maintain for petitioner the patronage of the Panczak and Flad customers - and continued customer patronage is the essence of goodwill. Accordingly, we believe a portion of the amounts putatively paid for the customer lists must be allocated to goodwill.

"Although a specific allocation in the purchase agreement, or in the negotiations leading thereto, may be the best evidence in determining the cost basis of an asset, if such evidence is not available, then we must make such an allocation on other available evidence. As is frequently the case, here the record is less than desirable. Nonetheless, we are satisfied that we can make an allocation between the customer lists and goodwill. Based on the record before us, we conclude that 25 percent of the stated amount for the customer lists is properly allocable to goodwill and the remaining 75 percent of the stated amount is properly allocable to the customer lists....

"Having ascertained the cost bases for the customer lists, we now turn to whether such lists have a limited business life. We find that they do.

"In determining whether an intangible, such as a customer list, has a limited business life, we consider a number of factors, including: testimony of expert witnesses, experience in the industry, testimony of officers, relationship of geographic area and the customers involved, turnover of customers (both before and after the acquisition of the list), and other pertinent factors...

"...Accordingly, we find the the Panczak and Flad customer lists each had a limited useful life of five years." [Citations omitted]

If the Third Circuit's decision in the instant case is permitted to stand, the value of all businesses having significant customer based intangible assets, including the members of PPA and FMANJ, will suffer a significant decrease. Furthermore, as a result of conflict among the circuits, the value of such businesses located within the jurisdiction of the Third Circuit may suffer such a loss while similar businesses elsewhere remain unaffected.

III

THE THIRD CIRCUIT'S DECISION IS IN CONFLICT WITH OTHER CIRCUITS, UNDERMINING THE UNIFORM AND FAIR ADMINISTRATION OF FEDERAL TAXATION

The Third Circuit's opinion that a customer based intangible asset acquired in conjunction with an underlying business as a going concern is not depreciable *as a matter*

of law is a clear departure from prior case law and disregards both the governing statute and regulations and the Internal Revenue Service's own interpretation as expressed in Rev. Rul. 74-456. As indicated above, since the decision in *Houston Chronicle, supra,* the issue of depreciability has uniformly been held to be a question of fact determined by reference to whether the particular intangible asset is shown to have (i) an ascertainable value separate and apart from goodwill and (ii) a limited useful life, the duration of which can be ascertained with reasonable accuracy. Accordingly, all customer based intangible assets shown to have a limited life and ascertainable value have been held depreciable.

The Third Circuit has ignored this precedent and is in direct conflict with decisions by the Fifth, Sixth, Seventh, Eighth, Ninth and Eleventh Federal Circuits as well as the U.S. Tax Court. (See petitioner's petition, pp. 14-15; *Houston Chronicle, supra* (5th Cir.); *Holden Fuel, supra,* (6th Cir.)). The Third Circuit decision thus creates an irreconcilable conflict among the circuits.

It should also be noted that the Third Circuit drew a distinction between contractually based and terminable-at-will customer relationships holding that if the customers were contractually obligated for a period of time, the purchaser could depreciate the value of the list over that time period. In the petroleum industry, many customers have service contracts which usually are for a term of one year. In the case of publication subscription lists, customers often contractually subscribe for a fixed period. One can only imagine the reaction of the Internal Revenue Service to any attempt by a purchaser of contractually bound customer based intangibles to depreciate the value of that asset over the term of the contract (a much shorter period than that currently required).

CONCLUSION

For the reasons set forth above, the Pennsylvania Petroleum Association and the Fuel Merchants Association of New Jersey respectfully request that Newark Morning Ledger Co.'s Petition for a Writ of Certiorari be granted.

Respectfully submitted,

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(3)

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
as successor to THE HERALD COMPANY,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Third Circuit

---

BRIEF OF INDEPENDENT INSURANCE AGENTS OF AMERICA, NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS, NATIONAL ASSOCIATION OF INSURANCE BROKERS, AND NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS, AS *AMICI CURIAE*, IN SUPPORT OF PETITION

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BRIEF OF INDEPENDENT INSURANCE AGENTS OF AMERICA, NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS, NATIONAL ASSOCIATION OF INSURANCE BROKERS, AND NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS, AS *AMICI CURIAE*, IN SUPPORT OF PETITION

INTRODUCTION

This brief is filed on behalf of the Independent Insurance Agents of America, the National Association

of Casualty & Surety Agents, the National Association of Insurance Brokers, and the National Association of Professional Insurance Agents (the "*Amici*") to respectfully urge this Court to grant Petitioner's Petition for a Writ of Certiorari. The written consents from the parties to the filing of this brief are attached.

INTERESTS OF THE *AMICI CURIAE*

Independent Insurance Agents of America is the nation's largest independent insurance agent association, representing over 220,000 agents and their employees. Its members offer all lines of insurance, including property, casualty, life, and health insurance.

The National Association of Casualty & Surety Agents represents 300 of the nation's leading insurance agencies and brokerages specializing in the sale and service of commercial insurance products to business, industry and municipalities.

The National Association of Insurance Brokers ("NAIB") is the national trade association of commercial insurance brokers. Founded in 1934, its members range in size from large international companies to regional and local firms representing clients throughout the United States and around the world. NAIB members administer the majority of all commercial property and casualty insurance in the United States.

The National Association of Professional Insurance Agents ("PIA") is a nonprofit trade association, representing 180,000 independent insurance agents and their employees who sell and service all lines of in-

surance, specializing in coverage for homes, automobiles and business. PIA is represented throughout the United States and Puerto Rico by members affiliated with forty-one PIA state or regional associations.

The *Amici* have a particular interest in this case for several reasons. First, given the nature of the insurance industry, substantial economic value is attributed to intangible assets such as policy expiration lists and customer lists. Accordingly, the holding of the Third Circuit directly and adversely would affect the federal income tax treatment of many members of the *Amici*. Second, the Third Circuit's decision, because it is in direct conflict with the holdings of other circuits, will result in disparate tax treatment among members of the *Amici*, depending upon the happenstance of business location. Third, because the Third Circuit's decision is at odds with the applicable tax statutes, it creates substantial uncertainty in the treatment of customer-based intangible business assets that have an ascertainable value and limited useful life.

This case presents the important federal income tax issue of whether terminable-at-will customer relationships acquired in the purchase of a going concern are depreciable under section 167 of the Internal Revenue Code. 26 U.S.C. § 167 (1986), as amended ("I.R.C."). This issue arises continuously in business acquisitions and dispositions of customer-based intangible assets by the members of the *Amici* and involves billions of tax dollars. Indeed, a recent General Accounting Office study, which specifically refers to the significance of intangible assets in the insurance industry as well as in other customer service industries, notes that

taxpayers have claimed depreciation deductions for $10.5 billion of customer-based assets and that the Internal Revenue Service has proposed adjustments in those matters aggregating over $4 billion in taxes. United States General Accounting Office, *GAO/GCD-91-99 Tax Policy, Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets (Aug. 1991).*

STATEMENT OF THE CASE

This case concerns specifically whether a depreciation deduction under I.R.C. section 167 may be taken by the Newark Morning Ledger Company (hereinafter "Morning Ledger") for the portion of the purchase price of eight Michigan newspapers which is allocable to identifiable subscriber relationships. The amount of the purchase price for those "paid subscribers" reflected an acquisition of distinct "customer-based" intangible assets.

To prevail on its claim for a depreciation deduction, Morning Ledger bore the burden of showing that the subscriber relationships had: (1) an ascertainable value separate and distinct from goodwill; and (2) a limited useful life that could be estimated with reasonable accuracy. App. A at 9a.[1] The Third Circuit accepted that Morning Ledger had shown that the intangible assets constituting the "paid subscribers" had (1) limited useful lives that could be estimated with reasonable accuracy, and (2) ascertainable value. However, the court further held that the subscription relationships were not "separate and distinct from goodwill"

[1] References are to pages of the Appendix to the Petition for a Writ of Certiorari.

because they reflected an "expectation of continued patronage" and, accordingly, were not depreciable. App. at 11a, 28a-29a. The court based its decision on the grounds that the "paid subscribers" were acquired by Morning Ledger in the purchase of an ongoing business and that the subscriptions were not "contractually-based." App. at 11a and 17a. Further, the court suggested that the intangible assets were not depreciable because Morning Ledger used an improper method of valuing the assets. App. at 30a.

The Third Circuit's decision announces a startling rule that conflicts with the rule in other circuits and that effectively creates a presumption that will be difficult, if not impossible, to refute—that customer-based intangible assets acquired as part of an ongoing business inherently are part of goodwill and, therefore, nondepreciable.[2] This rule unjustifiably elevates transactional form over substance. Moreover, it is in direct conflict with the law in the Fifth, Seventh, Eighth, Eleventh and Federal Circuits and the full Tax Court,[3] and is inconsistent with Congressionally recognized sound tax policy. In short, it fails to account for business and economic realities.

[2] It is not entirely clear whether the Third Circuit held such assets to be nondepreciable as a matter of law or whether, instead, it restated the applicable law to elevate a taxpayer's burden to the point that it would be incapable of proving that these assets are separate and distinct from goodwill.

[3] *See Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987); *Houston Chronicle Publishing Company v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974); *Super Food Services, Inc. v. United States*, 416 F.2d 1236 (7th Cir. 1969); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446 (Ct. Cl. 1976); *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990).

In arriving at its conclusion, the Third Circuit focused on the definition of "goodwill," accepting a "traditional" formulation that goodwill is "the expectation of continued patronage." App. at 10a-11a. Observing that "the projected stream of income to be generated by the 460,000 at-will subscribers is simply a quantification of Morning Ledger's expectation that these subscribers will continue their patronage," the Third Circuit held that the amount allocable to the "paid subscribers" constituted nondepreciable goodwill even though these intangible assets were shown to have limited useful lives that could be estimated with reasonable accuracy and ascertainable values.

REASONS FOR GRANTING THE PETITION

1. Certiorari Should be Granted to Resolve a Conflict Among the Circuits

The Third Circuit failed to recognize that the many authorities which refer to the "traditional" definition of goodwill fall into three categories: (a) cases of dated vintage that applied the now-repudiated "mass asset rule;"[4] (b) cases that resolve the depreciation issue on the ground that the taxpayer failed to carry its burden of proof (in establishing a limited useful life or

[4] Indeed, the Third Circuit's line of reasoning to the effect that "goodwill = expectancy of continued patronage = customer lists = goodwill" is virtually indistinguishable from the quintessential articulation of the discredited "mass-asset rule" contained in *Golden State Towel and Linen Service, Ltd. v. United States*, 373 F.2d 938, 942-44 (Ct. Cl. 1967). *See* App. at 14a n. 7.

an ascertainable value); and (c) cases in which the taxpayer carried its burden of proof and was, thus, entitled to depreciate intangible assets.[5] Many courts have reconciled the definition of goodwill with the allowance of depreciation deductions for discrete customer-based intangible assets acquired as part of an ongoing business if the taxpayer were to meet its burden. Indeed, that is the law in several circuits and in the Tax Court. *See, e.g., Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990); *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987); *Super Food Services, Inc. v. United States*, 416 F.2d 1236 (7th Cir. 1969); *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223 (1975), *acq.*, 65 T.C. 1153 (1976); *Los Angeles Central Animal Hospital, Inc. v. Commissioner*, 68 T.C. 269 (1977).

The Third Circuit essentially ignored the evolution of law from a *per se* (or "mass asset") rule—that customer-based intangible assets are so inextricably linked to goodwill as to be nondepreciable as a matter of law—to a recognition that such assets properly are depreciable in view of "the realities of modern business technology in a day when lists are bartered and

[5] A large part of the court's attention was focused on the *Houston Chronicle* case. App. at 8a-19a. It is inexplicable, though, how the Third Circuit considered the *Houston Chronicle* case to have conclusively buried "the notion that some intangible assets, although not necessarily goodwill, were nonetheless so intertwined with goodwill as to be nondepreciable as a matter of law in all cases—i.e., the mass asset rule" (App. at 16a), while at the same time it found *Houston Chronicle* to be the jurisprudential source for the conclusion that the subscription lists *necessarily* are goodwill if they are acquired as part of a going concern.

sold as discrete vendible assets." *Houston Chronicle*, 481 F.2d at 1253.

As noted by the Seventh Circuit:

> It is immaterial that the contracts may have no fixed termination date. [citations omitted] In our view, . . . it is also immaterial whether these [terminable-at-will] contracts were acquired separately or as part of a going business. Any quarrel with the going concern value of contracts acquired as part of a business is properly directed to the allocation to be made between goodwill and the contracts purchased and should not be relied on as requiring a complete denial of the depreciation deduction to contracts shown to have a limited useful life.

Super Food Services, Inc., 416 F.2d at 1240.

In the present case, the Third Circuit, in rejecting the holding of other circuits and, specifically, in "respectfully disagree[ing]" with the Eleventh Circuit's recent decision in *Citizens & Southern Corp.*, reverted to withering remnants of the mass asset rule. In so doing, the Third Circuit has created a clear conflict among the circuits.

2. Certiorari Should be Granted Because the Third Circuit's Decision is Inconsistent with Tax Policy

A fundamental premise of United States tax policy is that income should be matched, to the extent possible, with expenses incurred to reach a reasonable determination of net (or taxable) income. The Third Circuit's decision undermines that policy.

Ordinarily, a buyer of an ongoing business that has stable, existing customer relationships would expect to earn income from those existing customer accounts. That income stream typically is quantifiable with reasonable certainty over the remaining useful life of the acquired customer accounts. Accordingly, a buyer invariably would take into account the value of those customer relationships, as it would the value of tangible personal property, such as supplies and equipment, in determining the price it would pay for the business.

Under the Internal Revenue Code, depreciation deductions are allowable in reaching a true net income, permitting a taxpayer to offset revenues by a part of the price paid for "wasting" assets. I.R.C. § 167; Treas. Reg. §§ 1.167(a)-1 (1972); 1.167(a)-3 (1960). This allowance accounts for the exhaustion of assets used in business. It is intended to provide a deduction that correlates to the income-producing life of the asset. Thus, as a matter of sound tax policy, a taxpayer should be entitled to recover, through depreciation deductions, the allocable cost of customer-based intangible assets if those assets are shown to have a limited useful life, estimated with reasonable accuracy, and an ascertainable value.[6] That an intangible asset can be shown to have a limited useful life serves to distinguish it from nondepreciable goodwill.

Denying a taxpayer, such as Morning Ledger, the recovery of the cost of a wasting asset that has a

[6] This approach also is consistent with Generally Accepted Accounting Principles which are drawn to reflect economic income. AICPA Accounting Principles Board Opinion No. 17.

determinable value separate and distinct from goodwill and a limited useful life is wholly inconsistent with sound tax policy. It results in an overstatement of income. That result is inconsistent with the fundamental premise of the federal income tax system—to tax only *net* income.

In reaching a decision that is inconsistent with tax policy, the Third Circuit also unfairly discriminates against service industries. In a manufacturing business, a portion of the income stream expected to be generated by equipment, for example, would be reflected in the value of the tangible property, i.e., the manufacturing equipment. In service industries, such as the insurance industry of the *Amici*, a major portion of the value of a business is reflected in contractual relationships with customers—whether or not terminable-at-will. Similar to the subscriber relationships purchased by Morning Ledger, insurance businesses create substantial value through policyholder relationships. To deny depreciation deductions for these intangible assets unfairly and improperly would deprive the service industries of tax benefits allowable to other industries.

Furthermore, a careful review of the historic underpinnings for disallowing depreciation deductions for goodwill suggests strongly that the scope for defining "goodwill" for tax purposes should be narrowly limited. The proscription against amortizing goodwill originally appeared in an amendment to Article 163 of Treasury Regulation 69. T.D. 4055, VI-2 C.B. 63; Regs. 69, Art. 163 (Revenue Act of 1928). That amendment was prompted by a case that concerned whether a decline in the value of goodwill of a brewery attributable to the onset of Prohibition justified

a deduction. In that litigation, this Court overruled the Second Circuit,[7] and held that goodwill was not amortizable. *See Clarke v. Haberle Crystal Springs Brewing Co.*, 280 U.S. 384 (1930). That, however, is a far cry from the issue in the present case.

In light of this history, and accepting that the objective of our tax system is that *net* income accurately should be measured, sound tax policy argues strongly in favor of narrowing, rather than broadening, the definition of goodwill. Accordingly, the Third Circuit erred in expanding the definition to include all intangible assets that contribute to the expectancy of customer patronage, even though those assets have a limited useful life and an ascertainable value.

3. Certiorari Should be Granted Because the Third Circuit's Decision Creates an Unsupportable Distinction in Treatment of Customer-Based Intangible Assets

Routinely, in the insurance industry as in the newspaper industry, customer-based intangible assets—such as subscription lists, insurance expiration lists, policyholder lists, and other existing customer accounts—can be and are purchased separately from an ongoing business. Frequently, though, such assets are acquired as part of the purchase of a going concern. The Third Circuit apparently conceded that if such intangible assets are purchased separately they properly may be amortized for federal income tax purposes. App. at 17a. But, the court distinguished instances in which those same assets are purchased as part of an ongoing business, suggesting that the assets lose their identity and are transformed into unamortizable goodwill. *Id.*

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[7] *Haberle Crystal Springs Brewing Co. v. Clarke*, 30 F.2d 219 (2d Cir. 1929).

This distinction unjustifiably elevates the form of a transaction over its substance. Rather, the proper perspective has been noted by the Fifth Circuit in *Houston Chronicle*, "[a]mortizability for tax purposes must turn on factual bases—[this view] is more in accord with the realities of modern business technology in a day when lists are bartered and sold as discrete vendible assets." *Houston Chronicle*, 481 F.2d at 1253. Whether those assets are sold as idle assets of a defunct company or as assets of a going concern has no relevance to determining whether they are depreciable.

4. Certiorari Should be Granted Because the Third Circuit's Decision Disregards Acceptable Valuation Methods

The Third Circuit's decision effectively forecloses use of acceptable, and in some instances required, methods for distinguishing customer-based intangible assets from goodwill and for valuing those intangible assets. Specifically, the holding restricts, if it does not render wholly unavailable, the use of the "residual method" for separating customer-based intangible assets from goodwill. It further limits taxpayers to use of the "cost method" of valuing intangible assets, effectively proscribing use of the income stream, or capitalization of earnings, method.

The residual method for allocating the purchase price of multiple assets, which method in many instances is *mandated* by law, provides for the allocation of value to all assets *other than* goodwill, including intangible assets whether or not depreciable, *before* making an allocation to goodwill. *See* 26 U.S.C. §§ 338(b)(5), 1060 (1986); Treas. Regs. §§ 1.338(b)-2T(b) (1986); 1.1060-1T(d)(1988). The Third Circuit apparently was unaware that the Congress not only has approved use of the residual method to value goodwill separately from intangible assets, but in fact has *required* such treatment. Moreover, case law preceding the enactment of I.R.C. sections 338 and 1060 (including, curiously, a Third Circuit decision) applied the residual method to determine goodwill in appropriate circumstances.[8]

Further, in enacting I.R.C. section 1060, Congress explicitly recognized that the income stream, or capitalization of earnings, method for determining allocable value is a commonly accepted method of asset valuation for the purpose of determining tax basis in an acquisition of a going business.[9] In its ruling, however, the Third Circuit effectively denied use of the income stream method, opining that Morning Ledger "gambled" in its use of that method. App. at 30a. To the contrary, Morning Ledger used a method, supported with expert testimony, that is commonly accepted and, indeed, approved by Congress.

The court compounded its error in suggesting that *if* Morning Ledger has used the cost method, the

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[8] *See, e.g., Jack Daniel Distillery v. United States*, 379 F.2d 569, 579 (Ct. Cl. 1967); *R.M. Smith, Inc. v. Commissioner*, 69 T.C. 317, 320-323 (1977), *aff'd*, 591 F.2d 248 (3d Cir.), *cert. denied*, 444 U.S. 829 (1979). The residual method generally has been viewed as more favorable to the government than alternative methods because it typically results in a greater allocation to goodwill. *See Philip Morris, Inc. v. Commissioner*, 96 T.C. No. 23 (1991).

[9] S. Rep. No. 313, 99th Cong., 2nd Sess., p. 252 (1986). *See also General Explanation of the Tax Reform Act of 1986* (Committee Print, 1987) at 356 (explaining the status of the law prior to enactment of section 1060).

intangible assets would have become depreciable. The error in the court's reliance on the cost method and rejection of the income stream method is revealed in the facts. At trial, the lower court found:

> In response to the expert opinions submitted by plaintiff, [the Service] offered experts who were unqualified, valued the wrong asset and utilized inappropriate methodology.

Newark Morning Ledger Co. v. United States, 734 F. Supp. 176, 181 (D.N.J. 1990). That the Service's experts valued the "wrong asset" underscores the deficiencies of applying the cost method in valuing intangible assets and highlights the error of the Third Circuit's decision.

CONCLUSION

The issue raised in this matter is of considerable significance in the administration of the federal income tax laws. It has broad and direct application to members of the *Amici*, as well as to other industries. In this case, the Third Circuit has relied upon discredited tax notions while disregarding other valid, acceptable, even mandated tax principles. It has infected the treatment of customer-based intangible assets with substantial uncertainty and has created a direct conflict with decisions of other circuits. For

these reasons, *Amici* respectfully urge that the Court grant the Petition For Writ of Certiorari.

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No. 91-1135

IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF AMICUS CURIAE OF AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION IN SUPPORT OF PETITION FOR CERTIORARI

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BRIEF AMICUS CURIAE OF AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION IN SUPPORT OF PETITION FOR CERTIORARI

STATEMENT OF INTEREST

AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION (ANPA) is a non-profit trade association representing approximately 1,300 member newspapers. Its membership includes the publishers of newspapers that are responsible for about 90 percent of the total daily and Sunday newspaper circulation, and a substantial portion of the non-daily newspaper circulation, in the United States.

ANPA submits this brief *amicus curiae* in support of the petition for a writ of certiorari.* The issue at the heart of this case will directly affect ANPA members that have negotiated transactions in reliance on the heretofore settled rule that the availability of an amortization deduction for purchased intangible assets is a factual question. If the Third Circuit's opinion is allowed to stand, similarly situated ANPA members will be taxed differently, both at the administrative level and by the courts, depending on whether they happen to be subject to the jurisdiction of the Third Circuit.

SUMMARY OF ARGUMENT

The Third Circuit's decision has created a split in the circuits that will result in non-uniform treatment of similarly situated ANPA members. Under the law as it now stands, ANPA members outside the Third Circuit's jurisdiction have the right to prove, as a factual matter, that the amount paid for purchased newspaper subscribers is amortizable. Those members within the Third Circuit's jurisdiction do not.

Moreover, the issue before the Court of Appeals—the amortizability of customer relationships—is one that has been repeatedly considered by courts in the past, and will continue to arise in the future. Given (a) the issue's long history, (b) the expectation that ANPA members will continue to claim that purchased newspaper subscribers are subject to amortization, and (c) the Internal Revenue Service's stated position that such assets are nonamortizable as a matter of law, taxpayers and the Service will continue to litigate the eligibility of newspaper subscribers for amortization until this Court resolves the issue.

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* Written consents of both parties have been filed with the Clerk of the Court as required by Supreme Court Rule 37.

ARGUMENT

I. CERTIORARI SHOULD BE GRANTED BECAUSE THERE IS A SPLIT IN THE CIRCUITS, CAUSING TAXPAYERS TO BE TREATED DIFFERENTLY DEPENDING ON THE CIRCUIT IN WHICH THEY HAPPEN TO RESIDE.

The Court of Appeals for the Third Circuit ruled in the instant case that the value of terminable-at-will customer relationships is, *as a matter of law*, nonamortizable goodwill for federal income tax purposes. This ruling is plainly inconsistent with the decision of the Court of Appeals for the Seventh Circuit in *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987), a case that is factually indistinguishable from the instant case. Indeed, the Third Circuit itself admitted that *Donrey* "is undeniably similar to the instant dispute in terms of the material aspects of the transaction." (App. 18a.)

Both *Donrey* and the instant case involved the tax treatment of purchased newspaper subscribers. In both cases, the taxpayer acquired the subscribers when it purchased an ongoing newspaper. In both cases, the taxpayer valued the subscribers using the income approach. Although the taxpayer in *Donrey* was allowed to prove (and did prove) the amortizability of the subscribers as a factual matter, the taxpayer in the instant case was denied that opportunity by the Third Circuit. Therefore, there is a clear split between the Third and Eighth Circuits.

The split among the Courts of Appeal is not limited to the split between *Donrey* and the instant case. For example, the Court of Appeals for the Eleventh Circuit in *Citizens & Southern Corp. v. Commissioner*, 919 F.2d 1492 (11th Cir. 1990), *aff'g*, 91 T.C. 463 (1988), affirmed the holding of the Tax Court that the "core deposits" of a bank are amortizable for federal income tax purposes. Core depositors of a bank are analogous to subscribers of a newspaper. In both cases, the busi-

ness uses a relationship—with the subscriber in the case of a newspaper and with the core depositor in the case of a bank—to generate earnings from the other customers of the business: the advertisers in the case of a newspaper, the borrowers in the case of a bank. In neither case is there a contractual arrangement that ensures the continued patronage of the subscribers or depositors. In both cases, the businesses know that their subscribers or depositors will remain for determinable periods of time. Therefore, both situations involve terminable-at-will relationships with determinable lives that enable the business to generate earnings from its other customers.

The Third Circuit agreed that there is no principled distinction between the factual situation in the instant case and that in *Citizens & Southern*. It stated:

> We could attempt to distinguish *Colorado National* [*Colorado National Bankshares, Inc. v. Commissioner*, 60 T.C.M. (CCH) 771 (1990)] and *Citizens & Southern* from the instant dispute. We believe, however, that such an exercise ultimately would prove pointless and would be somewhat disingenuous.

App. 23a. Despite the acknowledged similarity between *Citizens & Southern* and the instant case, the two taxpayers involved were treated differently. The taxpayer in *Citizens & Southern* was allowed to demonstrate the facts necessary to amortize the value of the terminable-at-will customer relationships. The Third Circuit denied this opportunity to the taxpayer in the instant case. Therefore, there is also a clear split between the Third and Eleventh Circuits.

The petition for certiorari discusses other cases that conflict with the decision of the Third Circuit in the instant case. There can be no question, then, that the Third Circuit's decision is unique, and inconsistent with the rules in several other circuits.

The resulting split in the circuits is of great practical concern to the members of ANPA, and suggests the need

for this Court to address the issues raised. Many ANPA members have in the past acquired other newspapers, and many will acquire newspapers in the future. For example, information published in *Editor & Publisher*, a magazine serving the newspaper business, shows that from 1985 through the end of 1991, approximately 370 daily newspapers were acquired, or an average of more than fifty per year. *Editor & Publisher*, January 4, 1986, pp. 46-49; January 3, 1987, pp. 52-56; January 2, 1988, pp. 46-48; January 7, 1989, pp. 48-52; January 6, 1990, pp. 60-64; January 5, 1991, pp. 50-53; January 4, 1992, pp. 44-46. Not all of these acquisitions were of or by ANPA members, and not all of them resulted in the acquirer claiming amortization deductions for purchased subscribers. Nevertheless, ANPA is aware that in at least the larger acquisitions, purchasers took the position that a portion of the purchase price was properly attributable to the subscribers and claimed amortization deductions for the amount attributable to those subscribers. Those newspaper purchasers not subject to the jurisdiction of the Third Circuit have the right to prove, as a factual matter, that the purchased subscribers are eligible for amortization. Those newspaper purchasers subject to the jurisdiction of the Third Circuit have no such right. The result is that our tax system treats ANPA members differently, depending on the circuit that has jurisdiction over their tax disputes. ANPA submits that this Court should address this inherent unfairness by resolving the conflict among the circuits.

The discriminatory impact on ANPA members arises not only in the event of an audit by the Internal Revenue Service (the "Service") of a past transaction. It will also arise in the future as ANPA members contemplate purchasing other newspapers. A potential purchaser that is not subject to the jurisdiction of the Third Circuit can offer a price for a newspaper that is higher than could be offered by a potential purchaser within the Third Circuit, simply because the former can assume it

will pay less tax on the newspaper's operations by virtue of amortization deductions. (The availability of amortization will generally depend on the location of the *purchaser*, and not the location of the newspaper being purchased.) Therefore, the effect of the Third Circuit's opinion is to artificially tilt the playing field in favor of non-Third Circuit newspaper purchasers, thus leading to economic inefficiency.

The impact of the Third Circuit's decision goes far beyond the newspaper industry, because other industries —such as the banking industry—have analogous intangible assets. Thus, the split in the circuits will result in similarly situated non-newspaper companies being taxed differently, depending on whether or not they are located in the Third Circuit.

II. THE ISSUE ADDRESSED IN THIS CASE IS ONE THAT WILL CONTINUE TO BE LITIGATED UNLESS THIS COURT RESOLVES IT.

The issue addressed by the Third Circuit—the amortizability of terminable-at-will customer relationships—is one that has recurred over a long period. ANPA members will continue to purchase newspapers, and will continue to take the position that the portion of the purchase price attributable to purchased subscribers is amortizable.

ANPA also expects that the Service will routinely disallow amortization deductions at the audit stage, and perhaps within the Appeals Office of the Service as well. The Service has initiated an "Industry Specialization Program" for selected industries, including the media industry, with an "industry specialist" for each selected industry. See Internal Revenue Manual ("IRM")—Audit, Chapter 900, "Industry Specialization", and Part 42(14), "Industry Specialization Program". As part of that program, the Service identifies tax issues relating to a particular industry and develops a position paper on

each identified issue. IRM 42(11)8, Section 952(3). After the Service's National Office Examination Function approves an issue, it becomes an official "coordinated issue" for the industry. IRM 42(11)8, Section 952(9).

Pursuant to IRM 42(14)5.1(1), an agent auditing a return may not adopt a position contrary to that reflected in a coordinated issue without the specific concurrence of the industry specialist. See also IRM 42(14)5.21(f) and IRM 42(14)5.22(d) (both district case managers and group managers are required to follow decisions on coordinated issues formulated by the industry specialist, unless a deviation is approved by the industry specialist and the national industry coordinator). Thus, the Service is attempting to make uniform its treatment of taxpayers in certain industries, including the media industry.

Pursuant to the industry specialization program for the media industry, the Service adopted an "ISP Coordinated Issue Paper" on customer based intangibles. That coordinated issue paper states in part that

> . . . if the customer based intangible represents the customer structures of the acquired business, and that business possesses characteristics of goodwill, then the intangible is inseparable from goodwill, and thus, is nonamortizable *as a matter of law*.

ISP Coordinated Issue Paper, Customer Based Intangibles, page 3 (undated; emphasis added). The coordinated issue paper confirms that the Service's position is that the asset at issue in this case is nonamortizable as a matter of law; moreover, as described above the Service has put in place procedures to enforce that position on audit.

Thus, while taxpayers will continue to claim amortization deductions for assets like newspaper subscribers, the Service has taken the institutional position that those assets are not amortizable as a matter of law. The question of the eligibility of those assets for amortization will

therefore recur in the courts until this Court resolves the split among the circuits.

CONCLUSION

Without review by this Court, similarly situated ANPA members will receive differing tax treatment, whether they are the subject of an audit for a past newspaper acquisition or contemplating purchasing newspapers in the future. Without guidance from this Court, the issue of the amortizability of terminable-at-will customer relationships is destined to be litigated by taxpapers and the Service for the foreseeable future.

For the foregoing reasons, ANPA submits that the petition for a writ of certiorari should be granted.

Respectfully submitted,

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Respondent.

On Petition for A Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the Third Circuit, in acknowledged conflict with other circuits and the United States Tax Court, was correct that under the Internal Revenue Code an income-producing wasting intangible asset may be nondepreciable "goodwill" as a matter of law.

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Respondent.

BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF THE AMICUS CURIAE

The American Bankers Association ("ABA") is the principal national trade association of the commercial banking industry in the United States. ABA members are located in each of the fifty states and the District of Columbia and represent banks of all types and sizes—money center, regional and community banks. ABA members hold approximately ninety percent of the domestic assets of United States banks.

The decision of the Third Circuit Court of Appeals in the above referenced case raises issues of major importance to commercial banks across the nation. The tax treatment for the amount paid by Newark

Morning Ledger Company for subscriber relationships is similar to the treatment that financial institutions use in their purchases of bank-related intangible assets. In the court below's decision, a reference is made that the core deposit intangible is akin to subscriber relationships and therefore, under their analogy, may not be amortizable. As such, the decision of the Third Circuit exposes financial institutions located in that jurisdiction and in other jurisdictions which have not addressed the depreciation of bank-related intangible assets to unwarranted risk, and conflicts directly with judicial and long-standing policies of the Internal Revenue Service ("IRS"). The Third Circuit's decision represents a substantial and legally unjustified shift in the law of depreciation of intangible assets.

The Third Circuit's decision incorrectly characterizes the law of depreciation of intangible assets established by judicial decisions as well as the regulations and rulings of the Internal Revenue Service. The Third Circuit's holding sows confusion over the allowability of depreciation deductions for mortgage servicing rights, core deposits, and other intangible assets routinely acquired by banks in connection with the purchase of a going concern. The Third Circuit's attempt to impose a *per se* legal standard in lieu of a facts and circumstances test for the depreciability of intangible assets is fundamentally inconsistent with decades of settled legal authority and makes it extremely difficult to determine what tax consequences a bank may expect to result from the purchase of another bank.

Consideration of the facts and circumstances in the banking industry, in particular, demonstrates the fallacy of the Third Circuit's attempt to impose a *per se* rule denying depreciation deductions. The effect of the Third Circuit's decision is to create great uncertainty as to the cost of bank acquisitions and to jeopardize the depreciation deductions claimed by banks located in that jurisdiction as well as banks located in other jurisdictions in which a similar attempt may be made to abandon established precedent governing the depreciation of intangible assets.

The American Bankers Association is in a unique position to express the views of financial institutions regarding the issues raised in this case. Core deposits (*e.g.*, deposit transaction accounts, savings accounts) are the life blood of a commercial bank's existence and are the most valuable assets acquired in the purchase of a bank. The acquiring bank is willing to pay a "premium" for the value of these deposits as they represent a ready source of funds that the acquiring institution can immediately employ, albeit for a limited time. If this decision is allowed to stand, the banking industry may bear significant, negative consequences if the decision is interpreted broadly by other courts and the Internal Revenue Service. The American Bankers Association believes that its views would be of assistance to the Court in determining whether this matter merits further review. Counsel for both parties have consented to our appearance as amicus curiae. Copies of their written consents are filed together with this brief.

SUMMARY OF THE ARGUMENT

The Petition for Writ of Certiorari describes the serious practical problems created by the Third Circuit's ruling for purchasers of intangible assets from

going concerns. This brief explains the adverse impact of the court's ruling on the banking industry. In particular, the analogy made by the Third Circuit between the amortizability of the core deposit intangible in the context of bank acquisitions and the amount paid for subscriber relationships in the case of newspaper acquisitions concerns our members.

The decision by the Third Circuit misconstrues the standard for depreciation of intangible assets under section 167 of the Internal Revenue Code, 26 U.S.C. Section 167 (1988 & West Supp. 1991). Prior to the decision of the Third Circuit, modern judicial decisions interpreting the Internal Revenue Code and Treasury regulations had unanimously held that entitlement to depreciation is a question of fact, and established that an asset is depreciable if, as a matter of fact, it has an ascertainable value separate and distinct from goodwill and a limited useful life that can be estimated with reasonable accuracy. The case law, until now, has been quite clear that those questions, including specifically, whether an asset is "separate and distinct" from goodwill, are questions of fact.

In the ruling below, however, the Third Circuit ignored or mischaracterized the case law pertaining to depreciation of intangible assets in order to create a new legal standard. In essence, the court below erroneously viewed the dispute not as a question of fact but as a question of law.

The question analyzed by the Third Circuit was whether an asset is necessarily separate and distinct from goodwill if it has both a separate value and a limited life. The Third Circuit, however, did not address the question whether the subscriber relationships acquired by the taxpayer were, as a matter of

fact, separate and distinct from goodwill. Instead, the decision of the court established a new legal standard that a customer-based intangible cannot be separate and distinct from goodwill if it is acquired in the context of the purchase of all the assets of a going concern.

In changing from a factual standard to a legal standard that establishes a *per se* rule of nondepreciability, the Third Circuit's decision is a complete break from the modern case law of intangible asset depreciation. The Third Circuit's holding would appear to virtually bar depreciation of customer-based intangible assets acquired in the context of the purchase of an ongoing business. For that reason, the court's holding is already sending shock waves through the banking community and other industries in which the purchase and sale of customer-based intangibles play a major role.

The Third Circuit's mischaracterization of the law of depreciation of intangible assets has potential ramifications far beyond the particular intangible asset and the particular taxpayer at issue in this case. The American Bankers Association urges the court to grant the Petition for Writ of Certiorari and to consider the significance of these issues and the disparate treatment of similarly situated taxpayers which is likely to occur if this decision is permitted to stand.

REASONS FOR GRANTING WRIT

I. The Third Circuit's Decision Conflicts With The Decisions Of Other Circuits And Misstates Existing Law.

The Third Circuit's holding incorrectly characterizes the law of depreciation of intangible assets established

by judicial decisions as well as the regulations and rulings of the Internal Revenue Service.

The basic elements necessary to depreciate an intangible asset are set forth in section 167(a) of the Internal Revenue Code and section 1.167(a)-3 of the Treasury regulations. These authorities have been interpreted by the landmark case of *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) and subsequent cases as establishing a two-part test: (1) the asset must have an ascertainable value separate and distinct from goodwill, and (2) the asset must have a limited useful life that can be ascertained with reasonable accuracy.

The *Houston Chronicle* decision ushered in the modern era of judicial decisions involving the depreciation of intangible assets. *Houston Chronicle* held that the determination of whether an asset satisfies the standard for depreciation is a factual determination. In that case, the Government argued that the acquired newspaper subscriber relationships should be considered nondepreciable as a matter of law. After an exhaustive review of the case law, the Fifth Circuit rejected the Government's argument. The court concluded that most of the cases applying the "mass asset" rule, a sobriquet for the *per se* rules of nondepreciability urged by the Government, involved *evidentiary* failures on the part of the taxpayer. With the exception of the Third Circuit's decision, the *Houston Chronicle* holding that depreciation is available if the taxpayer can make the necessary *factual* showing has been approved by all of the appellate courts to consider the issue. *See, e.g., Panichi v. United States*, 834 F.2d 300 (2nd Cir. 1987); *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987); *McCarthy v. United States*, 807 F.2d 1306 (6th Cir. 1986); *Ralph W. Fullerton Co. v. United States*, 550 F.2d 548 (9th Cir. 1977); *Citizens and Southern Corporation and Subsidiaries v. Commissioner*, 91 T.C. 463 (1988), *aff'd per curiam*, 900 F.2d 266 (11th Cir. 1990).

More than 25 years ago, the Commissioner issued several revenue rulings which suggested that certain intangible assets were nondepreciable as a matter of law. *See* Rev. Rul. 65-175, 1965-2 C.B. 41, and Rev. Rul. 65-180, 1965-2 C.B. 279. One year after the Fifth Circuit's seminal decision in *Houston Chronicle*, the Commissioner modified his 1965 rulings to remove any implications that customer-based intangibles, and similar assets, are indistinguishable from goodwill as a matter of law; and instead, stated that the depreciability of assets of this nature is a factual question. *See* Rev. Rul. 74-456, 1974-2 C.B. 65, 66.

In short, the case law and the Commissioner's own rulings make plain that there are no *per se* rules. Nevertheless, the Third Circuit's decision misapplies the case law in order to create a *per se* rule that purports to deny depreciation in the case of customer-based intangibles acquired in connection with the purchase of a going concern.

Although the court below recognized and indeed purported to apply the holding of *Houston Chronicle*, it was so severely misapplied that the *per se* rule adopted by the Third Circuit is the very same litigating position rejected by the Fifth Circuit in *Houston Chronicle*. In all of the intangible asset depreciation cases since *Houston Chronicle*, no appellate court has ever taken the position adopted by the court below. For example, in *Donrey*, the Eighth

Circuit upheld the depreciability of newspaper subscriber relationships acquired from a going concern.

The court below dismisses *Donrey* by making the startling claim that *Donrey* is inconsistent with *Houston Chronicle*. Far from being inconsistent with *Houston Chronicle*, *Donrey*, instead, is a straightforward application of the rule of *Houston Chronicle* that entitlement to depreciation is a question of fact. One of the facts determined by the trier of fact (in that case a jury) was that the newspaper subscriber relationship acquired by the taxpayer was an asset that is separate and distinct from goodwill. Accordingly, applying the *Houston Chronicle* test, the taxpayer was entitled to depreciate the value of the acquired asset over its limited useful life.

Although the Third Circuit conjured up an imaginary conflict between the Fifth Circuit (*Houston Chronicle*) and the Eighth Circuit (*Donrey*), it curiously failed even to mention the Fifth Circuit's application of the rule of *Houston Chronicle* in the context of intangible assets acquired from a going concern. In *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978), for example, the Fifth Circuit upheld the depreciability of intangible assets acquired in the purchase of a going concern football franchise. Apparently, in the Third Circuit's erroneous view of the law, the Fifth Circuit is inconsistent with itself.

The court below states flatly that "customer lists are generally not depreciable when acquired in conjunction with the sale of the underlying business as a going concern." It may well be that, in any given case, a taxpayer cannot carry its burden of proving that, as a factual matter, an acquired customer-based

intangible is separate and distinct from goodwill. Rather than treat the issue as a question of fact, however, the court below reached its own conclusion, apparently applying a legal standard that establishes a *per se* rule of nondepreciability in cases involving customer-based intangibles purchased as part of a going concern. In so doing, the Third Circuit committed legal error by ignoring the teaching of *Houston Chronicle*, *Citizens and Southern*, *Donrey*, and the many other cases holding that there are no *per se* rules and that entitlement to depreciation is a question of fact. This conflict amongst the circuits must be resolved.

The Third Circuit's ultimate conclusion that the subscriber relationship in this case is not separate and distinct from goodwill may or may not be a proper outcome of the *factual* inquiry that is necessary in a depreciation case; but it clearly is not a proper conclusion based solely on a legal theory of a *per se* rule in lieu of a factual inquiry. For that reason, the American Bankers Association urges the court to grant the Petitioner's Writ of Certiorari.

By fundamentally altering the basic legal standard for depreciation of intangible assets, the Third Circuit's decision will wreak havoc and create devastating uncertainty concerning the treatment of purchased intangible assets. Banks and bank holding companies often acquire intangible assets when purchasing other banks, and these acquisitions occur with respect to failed banks as well as banks that are going concerns. The depreciability of some intangible assets, like mortgage servicing rights, has been settled law for decades and even now is unchallenged. *See, e.g.*, *First Pennsylvania Banking & Trust Co. v. Commissioner*,

56 T.C. 677 (1971), and cases cited therein. Other intangible assets have been held to be depreciable if they can satisfy the *Houston Chronicle* standard with proof of an ascertainable useful life and a value separate and distinct from goodwill.

The Third Circuit's faulty analysis of core deposit intangibles is disturbing because it ignores the facts of life in the banking industry as well as the established case law. In the banking industry, core deposits represent the literal life blood of a commercial bank's existence. The deposit transaction accounts, regular savings accounts and similar accounts afford a bank with a source of funds for a limited but predictable period of time. The acquiring bank is willing to pay a "premium" for these accounts as they provide the acquiring institution with immediate funds from which it can serve the local community. The value of an acquired group of core deposits can be determined by recognized valuation methods—and indeed, is one of the most valuable assets obtained in the purchase of a bank. The core deposit intangible is recognized by bankers, bank regulators, and accounting authorities as a separate source of value, separate and distinct from goodwill—and is purchased and sold in the marketplace in connection with the purchase of both failed institutions and going concerns.

Whether purchased from a failed bank or a going concern, the core deposit intangible asset is the same. It is a separate asset, with a limited useful life, and therefore is depreciable. In *Midlantic National Bank/ Merchants v. Commissioner*, 46 T.C.M. 1464 (1983), the Tax Court held in a memorandum decision that the value of the right to solicit the core deposits of a failed bank was a depreciable asset. In *Citizens and*

Southern, the entire Tax Court, in a reviewed decision, held that the value of the core deposits acquired from a going concern was an asset separate and distinct from goodwill, and that the value of that asset (measured by the cost savings of the acquired deposits over the cost of replacing those funds with the market alternative source of funds) is depreciable over its limited life.

Citizens and Southern was affirmed *per curiam* by the Eleventh Circuit. Although a bank was denied depreciation of an acquired deposit base in the earlier decision of *AmSouth Bancorporation and Subsidiaries v. United States*, 681 F.Supp. 698 (N.D. Ala. 1988), the court in that case was careful to state that depreciation was denied due to a failure of proof. The decision in *AmSouth Bancorporation* was appealed to the Eleventh Circuit, but the appeal was withdrawn before the Eleventh Circuit affirmed *Citizens and Southern*. Subsequently, *Citizens and Southern* was followed in the Tax Court memorandum decision in *Colorado National Bankshares v. Commissioner*, 60 T.C.M. (CCH) 771 (1990). Even more recently, after the Third Circuit's decision below, *Citizens and Southern* was again followed and reaffirmed by a reviewed decision of the entire Tax Court in *IT&S of Iowa, Inc., and Iowa Trust and Savings Bank v. Commissioner*, 97 T.C. No. 34 (November 12, 1991).

By attempting to impose a *per se* rule that ignores the facts in any particular case, the Third Circuit's decision introduces enormous uncertainty concerning the proper legal standard for depreciation of intangible assets, even intangible assets that are clearly recognized to be separate from goodwill. Every other circuit to consider the depreciation of intangible as-

sets has acknowledged that entitlement to depreciation is a question of fact. If permitted to stand, the Third Circuit's decision will continue to interfere with the administration of our tax system in a fair and consistent manner, and obstruct the purchase and sale of financial institutions and other businesses by creating unnecessary uncertainty concerning the tax consequences of purchasing intangible assets.

II. The Third Circuit's Decision Mischaracterizes The State Of The Law.

The Third Circuit's decision ignores the fact that, since *Houston Chronicle*, the law has been clear that depreciation is aquestion of fact. As even the Commissioner recognized in Rev. Rul. 74-456, customer-based intangibles, like other intangible assets, are eligible for depreciation if, as a matter of fact, they are separate and distinct from goodwill and have a limited useful life and a determinable value.

Congress has specifically declined to enact the proposed rule offered by the Commissioner, and apparently accepted by the Third Circuit, that some assets be declared nonamortizable as a matter of law. Indeed, Congress considered precisely such a proposal in 1987. Section 10120 of H.R. 3545, the Revenue Bill of 1987, proposed to deny amortization of subscriber relationships and similar intangible assets. Although H.R. 3545 was enacted as Title X of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, 1330-382 (1987), Congress did not enact the provision denying amortization of customer-based intangibles and similar assets, and has not enacted any of the more recent proposals to deny amortization of customer-based intangible assets.

The Third Circuit's decision has injected a great deal of confusion into this area as it departs from the settled standards established by other appellate decisions. This decision compounds the uncertainty of difficult factual determinations by introducing uncertainty even as to the underlying legal standard for depreciation in different circuits. That confusion can be rectified only by applying the same standard for depreciation in this case that has been applied in all of the appellate decisions since *Houston Chronicle*.

CONCLUSION

The decision in this case holds that, as a matter of law, a customer-based intangible is not depreciable when acquired in conjunction with the purchase of the entire business as a going concern. The overly-broad nature of the Third Circuit's decision causes great disruption in the acquisition of intangible assets. Given this disruption, the facts and circumstances test established by the *Houston Chronicle* decision should remain the legal standard for the amortizability of intangible assets.

The Petition for Writ of Certiorari should be granted and the decision of the Third Circuit should be reversed.

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No. 91-1135

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER,
as Successor to The Herald Company,
Petitioner.

VS.

UNITED STATES OF AMERICA,
Respondent.

MEMORANDUM OF AMICUS CURIAE MAGAZINE PUBLISHERS OF AMERICA, INC. IN SUPPORT OF PETITIONER

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No. 91-1135

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER,
as Successor to The Herald Company,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

MEMORANDUM OF AMICUS CURIAE MAGAZINE PUBLISHERS OF AMERICA, INC. IN SUPPORT OF PETITIONER

Amicus Magazine Publishers of America, Inc. (MPA) is a national trade association incorporated under the laws of the State of New York. It submits this brief in support of the petitioner's petition for a writ of certiorari.[1] MPA's membership includes 235 publishing firms that publish 1,193 consumer interest magazines. MPA members' publications include mass-circulation weeklies, monthly home and fashion magazines, journals of opinion, non-profit publications, and a wide variety of special interest publications. These publications are the leading magazines in an industry which sells approximately 9,000,000,000 subscription copies and 2,400,000,000 single issue newsstand copies per year.

[1] Written consent of the parties has been filed with the Clerk of the Supreme Court pursuant to Rule 37.

MPA members regularly acquire, collect and maintain extensive subscription and other demographic information regarding the subscribers to their publications.

In the 1980s a number of MPA members purchased magazines in asset or asset-equivalent transactions involving billions of dollars. The transactions were planned and executed with the expectation, based upon decided cases and respondent's own rulings and acquiescences, that the amounts expended for the acquired subscribers would be amortizable over the limited life of those subscribers under IRC § 167. Contrary to its earlier pronouncements, respondent now challenges the fundamental economic and tax assumptions upon which both buyers and sellers conceived and executed their transactions.

SUMMARY OF ARGUMENT

The Third Circuit misperceived the applicable precedent and created a conflict among the circuits. It substituted a restricted definition of goodwill found in the case law for the descriptions of depreciable intangible assets and non-depreciable (residual) goodwill found in the Treasury Regulations. While it relied upon *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974), it ignored the Fifth Circuit's rejection of "the establishment of a *per se* monolithic 'mass asset' theory that would amalgamate all subscription lists with goodwill." *Id.* at 1253.

Though the Third Circuit relied upon numerous cases for its definition of goodwill (App. at 23a-25a), it ignored the fact that in a number of these cases the court also determined that the taxpayer had acquired a separate and distinct, depreciable intangible asset. Additionally, the Third Circuit also failed to cite or rely upon the latest cases from the circuits which have considered the same issue.

Finally, the District Court has provided in its "galaxy of customers" description an appropriate "bright line" test to distinguish between separate and distinct, depreciable customer-based intangible assets and non-depreciable goodwill.

For these reasons, the Court should grant certiorari and reverse the decision of the Third Circuit.

ARGUMENT

I

THE THIRD CIRCUIT HAS MISPERCEIVED THE APPLICABLE LAW AND TREASURY REGULATIONS AND HAS CREATED A CONFLICT AMONG THE CIRCUITS

The decision of the Third Circuit is in conflict with decisions in many of the Circuits.[2] It is the result of a fundamentally flawed analysis of the applicable case law and statutory and regulatory provisions.

Goodwill is an elusive concept. Not properly defined, it has meant many different things to courts, taxpayers and the Internal Revenue Service. Properly defined and considered in the context of a long-standing Treasury Regulation,[3] however, non-deprecia-

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[2] The most recent relevant Circuit Court opinions are: *Panichi v. United States*, 834 F.2d 300 (2nd Cir. 1987) (purchase of a customer list only, and not an entire business); *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977); *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987) (acquisition of a business, including customer based intangible assets; holding that in *General Television, Inc. v. United States*, 548 F.2d 1148 (8th Cir. 1979), it held "[e]ntitlement to a depreciation deduction for an intangible asset is a question of fact." 809 F.2d at 536-37); *Commission v. Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966); *Citizens & Southern Co. v. Commissioner* 919 F.2d 1492 (11th Cir. 1990) (core deposit accounts acquired in the acquisition of a bank are depreciable); *Richard S. Miller & Sons, Inc.* 537 F.2d 446 (Ct.Cl. 1976); see also *Super Food Services, Inc. v. United States*, 416 F.2d 1236 (7th Cir. 1969), (separate intangible assets found to exist in purchase of grocery store business; this taxpayer victory was not mentioned in *Decker v. Commissioner*, 864 F.2d 51 (7th Cir. 1988)).

[3] Treas. Reg § 1.167(a)-3 provides:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a

ble (residual) goodwill is easily distinguished from depreciable intangible assets. The Fifth, Seventh, Eighth, Ninth, Eleventh and Federal Circuits and the Tax Court have determined that depreciable intangible assets can be segregated from non-depreciable goodwill in the purchase of an on-going business.[4]

It is essential in resolving the conflict between the circuits that the Court focus upon the *segregation* of "intangible assets . . . [having] a limited life, the length of which can be estimated with reasonable accuracy," from non-depreciable (residual) goodwill. This, after all, is the scheme which respondent itself has adopted in its recent regulations.[5]

The confusion about what the term "goodwill" has meant in various tax circumstances was summarized at length in *Meredith Broadcasting Co. v. United States,* 405 F.2d 1214, 1224-25, (Ct.Cl. 1968); and repeated in *Richard S. Miller & Sons, Inc. v. United States, supra,* 537 F.2d 446, 450-452, (Ct.Cl. 1976). Significantly, in both cases the Court of Claims held that if the useful life of an intangible asset could be shown to be of limited duration, and hence a "wasting asset," it would be considered to be distinct from "goodwill" and, therefore, depreciable. *Id.*

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depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance merely because, in the unsupported opinion of a taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

[4] *Laird v. United States,* (5th Cir.); *Super Food Services, Inc. v. United States,* (7th Cir.); *Donrey, Inc. v. United States,* (8th Cir.); *Commissioner v. Seaboard Finance Co.,* (9th Cir.); *Citizens & Southern Co. v. Commissioner,* (11th Cir); *Richard S. Miller & Sons, Inc. v. United States,* (Ct. Cl.) *supra;* and *IT & S of Iowa, Inc. v. Commissioner,* 97 T.C. No. 34 (Nov. 12, 1991).

[5] See IRC § 338 and § 1060 and Treas. Reg. § 1.338(b)-2T(b)(2) and § 1.1060-1(d)(2), where intangible assets are designated as "Class III" assets and goodwill is designated as a residual "Class IV" asset. That Congress and the Treasury would make this distinction undermines the Third Circuit's reliance on the "separate and distinct" language from the case law." *Infra,* pp. 5-7.

The Third Circuit quoted from *Miller* (App. at 20a), but ignored the distinction between depreciable intangible assets and non-depreciable goodwill found in the Treasury Regulation. It held that petitioner had not satisfied its burden of demonstrating that its paid subscribers were *"separate and distinct from goodwill."* (App. at 29a.)

The importance which the Third Circuit gave to the "separate and distinct" language was misplaced. This language is not found in the applicable statute[6] or Treasury Regulation.[7] While the "separate and distinct" language has its precedent in early case law, its application there suggests that even in 1926, the Eighth Circuit correctly distinguished non-depreciable goodwill from depreciable intangible assets which may be sold "separate and apart" from an established, on-going business.[8] Customer lists are such a "separate and distinct" asset.[9] Nowhere in the current precedent is there any support for the Third Circuit's conclusion

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[6] Section 167(a) provides:

(a) General Rule—there shall be allowed as a depreciation deduction a resonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolesence) (1) of property used in the trade or business, or (2) of property held for the production of income.

[7] Treas. Reg. 1.167(a)-3, at footnote. 2, *supra.*

[8] *Red Wing Malting Co. v. Willcuts,* 15 F.2d 626 (8th Cir. 1926), where the Eighth Circuit held that—

. . . good will has no existence *separate and apart* from an established business. With the termination of that business it is ended. While a capital asset, it is not the subject of purchase, sale, or assignment separate from the business itself. It is not an assignable asset distinct in the business itself. It is different in this respect from such intangibles as patents, contracts or franchises which may be sold.

[9] *Houston Chronicle Publishing Co. v. United States,* 481 F.2d 1240, 1253 (5th Cir.) cert. denied, 414 F.2d. 1129 (1974) ("Our view—that amortizability for tax purposes must turn on factual bases—is more in accord with the reality of modern business technology in a day when lists are bartered and sold as discrete vendible assets." *Id.*), *Manhattan Company of Virginia, Inc. v. Commissioner,* 50 T.C 78 (govt's appeal dismissed (*nolle pros,*), acq. 1974-2 C.B. 3; See also cases cited in fn. 12, *infra* at p. 7.

that an intangible asset, having an ascertainable value and a limited life, cannot be depreciated because it is inextricably interwoven with the general goodwill of the business.

When the Third Circuit relied upon *Houston Chronicle Publishing Co. v. United States, supra,* (App. at 16a), it erroneously overexaggerated the import of the "separate and distinct" language. Viewed in the context of the holdings in *Red Wing Malting, supra,* and *Miller, supra,* all that the "separate and distinct" language recognizes is that "goodwill" is not depreciable, but that an intangible asset, for which a taxpayer can demonstrate an ascertainable value and a limited life, is depreciable.

This is exactly what the Fifth Circuit held in *Houston Chronicle.* When that court referred to the acquired Houston Press subscription list as having "an ascertainable value separate and distinct from goodwill" it was referring to "goodwill" in the way that term is used in Treasury Regulation § 1.167(a)-3 (depreciable intangible assets are separate and distinct from non-depreciable (residual) goodwill).

This conclusion is compelled by the Fifth Circuit's additional holding in *Houston Chronicle* (481 F.2d at 1253):

> We reject, however, the establishment of a *per se* rule and a monolithic "mass asset" theory that would amalgamate all subscription lists with goodwill.

In light of this holding, the Third Circuit's reliance upon *Houston Chronicle* for the "separate and distinct" test was misplaced. Houston Chronicle was able to carry its burden of proof that it had acquired an amortizable intangible asset, having an ascertainable value and a limited and determinable useful life. *Id.* Similar proof was introduced by petitioner and found by the District Court in this case. (App. at 33a, *et seq.*)

Though respondent may argue that *Houston Chronicle* should be limited to the circumstance where only an amortizable intangible asset and not an ongoing business and its attendant intangible

assets are acquired, such is incorrect. First, the very fact that such intangible assets as customer lists can be freely traded in the market confirms that these assets have a determinable fair mark et value.[10] Second, even in its own practices, respondent has acquiesced[11] not only in *Houston Chronicle* and another single asset transfer case, *Manhattan Company of Virginia, Inc. v. Commissioner,* 50 T.C. 78 (1968), government's appeal dismissed (nolle pros.), acq. 1974-2 C.B. 3, but also in cases where the depreciable intangible asset was only a part of the business transferred and the assets transferred also included goodwill.[12] Respondent's acquiescences are inconsistent with its contention that the decision in *Houston Chronicle* and *Manhattan Company,* and its own Rev. Rul. 74-456, 1974-2 C.B. 65, only permit depreciation of an intangible asset when it is transferred separate from goodwill.[13] Finally, in *Laird, supra,* the Fifth Circuit extended its *Houston Chronicle* holding to the acquisition of a business having a number of intangible assets: "(t)hat the assets contribute value to one another does not prevent their severability for tax purposes." *Laird,* 556 F.2d at 1234.

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[10] See footnote 9, *supra*; See also Treas. Regs. 20.2031-1(b) (definiton of fair market value); and *United States v. Cartwright,* 411 U.S. 546, 551 (1973).

[11] 1974-2 C.B. 1: "Acquiescence in a decision means acceptance by the Service of the conclusion reached . . . (but) not necessarily . . . acceptance and approval of any or all of the reasons assigned by the Court for its conclusion."

[12] *Los Angeles Central Animal Hospital v. Commissioner,* 68 T.C. 269, 273-274 (1977), acq. 1978-2 C.B. 2; *Computing & Software, Inc. v. Commissioner,* 64 T.C. 223, 235 (1975) acq. 1976-2 C.B. 1; *First Pennsylvania Banking & Trust Co. v. Commissioner,* 56 T.C. 677 (1971) acq. 1972-1 C.B. 2.

[13] Respondent's acquiescences are seemingly on a par with its issuance of Private Letter Rulings. While neither is precedential, *per se,* both are examples of respondent's practices in considering such transactions. *Rowan Cos. v. United States,* 452 U.S. 247, 261, fn. 17 (1981).

II

THE THIRD CIRCUIT'S PHALANX OF CASES ARE MERELY YESTERDAY'S WARRIORS

In its opinion the Third Circuit refers to a "phalanx of cases" that have considered the definition and application of the term goodwill in the context of § 1.167(a)-3 . . . " (App. at 23a-25a.) Though these cases are noteworthy for their attempts to define "goodwill," the Third Circuit erroneously concluded that they also support respondent's position in this case. Merely because a court has defined goodwill in a broad or narrow sense does not mean that the court has also concluded that no "separate and distinct" intangible assets can be found in the amalgamated goodwill acquired.[14] Even more importantly, the cases relied upon by the Third Circuit are *not* the most recent pronouncements from the various circuits on this issue.[15]

III

THE DISTRICT COURT'S "GALAXY OF CUSTOMERS" DESCRIPTION PROVIDES A BRIGHT LINE TEST TO DISTINGUISH BETWEEN A DEPRECIABLE INTANGIBLE ASSET AND NONDEPRECIABLE GOODWILL

The District Court found that petitioner presented substantial uncontroverted proof about its subscribers and their past subscription practices. The court held that it was necessary to (App. at 32a-33a):

> distinguish between a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity and future purchases cannot be predicted, against subscribers who can be predicted to purchase the same item, for the same price on a daily basis.

In so finding, the District Court provided the Court, the respondent and taxpayers with a "bright line" test to distinguish depre-

[14] See *e.g. Commissioner v. Seaboard Finance Co.; Computing & Software, Inc.; Los Angeles Central Animal Hospital, supra.*

[15] See footnote 1, *supra.*

ciable, customer-based intangible assets from residual non-depreciable goodwill. Most publishers know their subscribers' history and can satisfy the two-pronged test set forth in Treas. Reg. 1.167(a)-(3). Those customers who select a newspaper or a magazine from a newsstand and pay cash are properly part of the "galaxy of customers" and a publication's residual goodwill. So too are the cash-only customers of a fast food restaurant or other similar enterprise—they show up at the counter one day, but no one knows whether they will return tomorrow. The behavior of petitioner's subscribers—and the amicus' subscribers—is statistically predictable and capable of satisfying Treas. Reg. 1.167(a)-(3).

CONCLUSION

The decision of the Third Circuit misperceives and disrupts the clear and unanimous decisions of the various circuits. The question of whether intangible assets, acquired individually or in the acquisition of a business, are depreciable is a question of fact to be determined based upon historical evidence. The Third Circuit's decision is at odds with the precedent in a number of circuits, is wrong and as a matter of law and unfairly reallocates the economic bases underlying many recent transactions. The Court should grant the petition and reverse the decision of the Third Circuit.

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IN THE

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OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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JOINT APPENDIX

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Nov. 9, 1988—Plaintiff Newark Morning Ledger Co.'s complaint filed in U.S. District Court for the District of New Jersey, Newark Division.

Jan. 25, 1989—Defendant's answer filed.

Dec. 18, 1989—Final pretrial order filed.

Feb. 5, 1990—Non-jury trial of action commenced.

Feb. 8, 1990—Interim Order regarding refund of federal taxes and interest paid for taxes years 1977-1980.

Feb. 9, 1990—Non-jury trial of action completed, decision reserved.

Apr. 3, 1990—Opinion of the District Court finding in favor of plaintiff.

May 25, 1990—Judgment of District Court entered for plaintiff.

June 4, 1990—Amended Judgment of District Court entered for plaintiff.

July 24, 1990—Defendant's notice of appeal filed.

Sep. 12, 1991—Opinion and judgment of the Court of Appeals for the Third Circuit reversing District Court.

Sep. 26, 1991—Petition by appellee for rehearing in banc.

Oct. 15, 1991—Order Amending Opinion of the Court of Appeals for the Third Circuit.

Oct. 15, 1991—Order denying petition for rehearing in banc.

UNITED STATES DISTRICT COURT
FOF THE DISTRICT OF NEW JERSEY

Civil Action No. 88-4836
Judge HLS

NEWARK MORNING LEDGER CO., AS SUCCESSOR TO THE HERALD COMPANY,
Star Ledger Plaza,
Newark, New Jersey 07101,
Plaintiff,

v.

THE UNITED STATES OF AMERICA,
Defendant.

[Filed Nov. 9, 1988]

COMPLAINT

Plaintiff, Newark Morning Ledger Co. ("Morning Ledger"), by its attorneys, as and for its complaint against defendant, the United States of America, alleges as follows:

PARTIES, JURISDICTION AND VENUE

1. Plaintiff Morning Ledger is a corporation organized and existing under the laws of the State of New Jersey, having its principal place of business at Court Street and University Avenue, Star Ledger Plaza, Newark, New Jersey 07101. Morning Ledger is the successor corporation to The Herald Company ("Herald"), which was liquidated by merger into Morning Ledger on June 30, 1987 in a transaction governed by Sections 332 and 334 (b)(1) of the Internal Revenue Code of 1954 (the "Code"). For many years prior to June 30, 1987, both corporations were engaged in the business of publishing daily newspapers. Morning Ledger continues to be so engaged. Herald was the transferee of the assets of

Booth Newspapers, Inc. ("Booth"), which was liquidated by merger into Herald on May 31, 1977 in a transaction governed by Sections 332 and 334(b)(2) of the Code as in effect at that time. Defendant is the United States of America.

2. Jurisdiction over this action for the recovery of internal revenue tax erroneously and illegally assessed and collected by the Internal Revenue Service (the "Service") is invoked in this Court pursuant to 28 U.S.C. § 1346 (a)(1).

3. Venue is proper in this Court pursuant to 28 U.S.C. § 1402(a)(2).

FACTS COMMON TO ALL COUNTS

4. In this action, Morning Ledger challenges several erroneous determinations by the Service affecting the total tax assessment against its predecessor, Herald, for calendar and taxable years 1977 through 1980. First, Morning Ledger challenges the Service's erroneous determination of the total adjusted basis in the assets acquired by Herald in the liquidation of Booth. Second, Morning Ledger claims that the Service erroneously determined the fair market values of certain of the assets distributed, namely, Booth's stock in Parade Publications, Inc. ("Parade"), "going concern value," newspaper subscribers, and goodwill. Third, Morning Ledger claims that the Service erroneously interpreted and applied the law with respect to how total adjusted basis is allocated to the property distributed in the liquidation. These errors resulted in the incorrect determination of adjusted basis in each of the assets acquired by Herald in the liquidation of Booth. Finally, Morning Ledger challenges the Service's erroneous determination that the values attributable to "going concern" and newspaper subscribers are nondepreciable. All these errors by the Service resulted in an unlawful and wrongful income tax assessment against Herald for tax years 1977 through 1980 amounting to nearly $35 million.

5. Before merging into Herald, Booth was a Michigan corporation having its principal place of business at Ann Arbor, Michigan. Booth was engaged primarily in the publication of daily and Sunday subscription newspapers of general circulation in eight Michigan communities. Booth's wholly-owned subsidiary, Parade, published *Parade*, a nationally distributed Sunday newspaper supplement.

6. During the period beginning February 12, 1976 and ending November 5, 1976, Herald purchased all the outstanding stock of Booth for a total cash consideration of $304,680,145. As determined by the Service and accepted by Herald, acquisition costs associated with the purchase totaled $2,878,311 giving Herald an agreed adjusted cost basis of $307,558,456 in the Booth stock.

7. In a series of transactions beginning on April 7, 1976 and ending on May 3, 1976, Booth purchased over 95 percent of the common stock of ComCorp, Inc. ("ComCorp").

8. On March 15, 1977, Booth sold its ComCorp stock to an unrelated third party for $2,744,700. On May 31, 1977, Booth was liquidated by merger into Herald.

9. Herald's total adjusted and allocable basis in the assets acquired in the liquidation of Booth was $345,556,722, as determined in accordance with Section 1.334 of the Treasury Regulations. This basis consists of Herald's $307,558,456 adjusted gross basis in the Booth stock, plus (a) the unsecured liabilities of Booth of $29,305,324 assumed by Herald, and (b) Booth's earnings and profits of $8,692,943, realized during the interim period between November 5, 1976, the date the stock was acquired, and May 31, 1977, the date of liquidation ("interim E&P").

10. On May 31, 1977 the fair market values of Booth's assets were as follows:

Assets	Fair Market Values
Cash and Equivalents	$ 15,617,042
Securities	37,249,852
Accounts and Notes Receivable	15,046,899
Master Repurchase Agreements	3,100,000
Deferred Charges and Deposits	323,944
Inventories	3,435,627
Land	4,658,885
Land Improvements	1,721,959
Buildings & Improvements	21,350,237
Production Equipment	17,109,130
Computer Hardware & Peripherals	1,300,435
Furniture and Fixtures	880,775
Office Equipment	731,195
Autos and Trucks	234,489
Investment in Parade	55,000,000
Going Concern Value	18,728,000
Computer Software	1,658,000
Newspaper Subscribers	64,155,000
Goodwill	51,695,685
Total:	$313,997,154

11. In accordance with Section 1.334 of the Treasury Regulations, the total adjusted basis in the Booth assets is properly allocated as basis among the assets received (other than Cash and Cash Equivalents) in the proportion to which the fair market value of each such asset relates to the total fair market value of all such assets, except that the adjusted bases of Accounts and Notes Receivable and of Master Repurchase Agreements are limited to the face value of such assets. This allocation of basis is as follows:

Assets	Adjusted Basis
Cash and Equivalents	$ 15,617,042
Securities	41,444,891
Accounts and Notes Receivable	15,046,899
Master Repurchase Agreements	3,100,000
Deferred Charges and Deposits	360,426
Inventories	3,822,544

Assets	Adjusted Basis
Land	5,183,564
Land Improvements	1,915,884
Building and Improvements	23,754,678
Production Equipment	19,035,942
Computer Hardware	1,446,889
Furniture and Fixtures	979,967
Office Equipment	813,541
Autos and Trucks	260,897
Investment in Parade	61,194,032
Going Concern Value	20,837,128
Computer Software	1,844,722
Newspaper Subscribers	71,380,068
Goodwill	57,517,598
Total:	$345,556,722

12. Upon audit of Herald's federal corporate income tax returns for the years 1977 through 1980, the Service determined deficiencies in tax in the amounts of $3,780,889, $3,121,205, $3,786,791, and $3,576,546, respectively. These alleged deficiencies, as well as a portion of Herald's total tax liability for each of those years, resulted in part from the Service's erroneous determination of the adjusted basis in the assets received in liquidation of Booth and the total disallowance of deductions claimed for depreciation of certain intangible assets, specifically, "going concern" value and newspaper subscribers.

13. As part of its erroneous determination of adjusted basis in each of the assets, the Service made the following errors in calculating the total adjusted basis in the assets of Booth:

(a) determined the amount of unsecured liabilities assumed by Herald, which is included in the total adjusted basis in the Booth assets acquired, to be $29,046,308 as opposed to the correct amount, which is $29,305,324;

(b) reduced the amount of interim E&P to be included in the total adjusted basis from $8,692,943 to a deficit of $5,038,906 as a result of:

(i) a reduction in depreciation deductions in the amount of $3,473,515;

(ii) the inclusion of an asserted loss in the amount of $3,036,967 on the March 15, 1977 sale of the ComCorp stock;

(iii) the elimination of after-tax depreciation recapture income in the amount of $14,176,198; and

(iv) the use of figures for taxable income (after adjustments), federal income tax liability, and other minor adjustments in the computations which are incorrect because of the other errors set forth in this paragraph.

14. As part of its erroneous determination of adjusted basis in each of the assets, the Service incorrectly made the following changes in the fair market values of the Booth assets:

(a) increased the fair market value of the stock in Parade from $55,000,000 to $100,000,000;

(b) increased the fair market value of "going concern" from $18,728,000 to $32,400,000; and

(c) increased the fair market value of goodwill from $51,695,685 to $79,786,296.

15. As part of its erroneous determination of adjusted basis in each of the assets, the Service incorrectly determined that the difference between (a) Herald's adjusted cost basis in the stock of Booth, plus the amount of assumed, unsecured liabilities, and (b) the fair market value of the identifiable tangible and intangible assets of Booth is allocable entirely to "goodwill".

16. As a result of its erroneous determination of total adjusted basis in the assets, the Service incorrectly determined that Herald's adjusted basis in each of the assets received in the liquidation of Booth was as follows:

Assets	I Adjusted Basis Determined by Service	II Correct Adjusted Basis
Cash and Equivalents	$ 15,617,042	$ 15,617,042
Securities	36,665,098	41,444,891
Master Repurchase Agreements	3,051,336	3,100,000
Accounts and Notes Receivable	14,810,688	15,046,899
Deferred Charges and Deposits	318,859	360,426
Inventories	3,381,695	3,822,544
Land	4,585,751	5,183,564
Land Improvements	1,694,926	1,915,884
Buildings and Improvements	21,015,080	23,754,678
Production Equipment	16,840,549	19,035,942
Computer Hardware	1,280,019	1,446,889
Furniture and Fixtures	866,948	979,967
Office Equipment	719,716	813,541
Autos and Trucks	230,807	260,897
Investment in Parade	98,430,188	61,194,042
Going Concern Value	31,891,381	20,837,128
Computer Software	1,631,974	1,844,722
Newspaper Subscribers	—	71,380,068
Goodwill—Residual Value	78,533,801	57,517,598
Total:	$331,565,858	$345,556,723

17. To the extent the adjusted basis in the assets determined by the Service as set forth in Column I of the previous paragraph differs from the adjusted basis in the assets set forth in Column II of the previous paragraph, the determination by the Service is arbitrary, capricious and erroneous. The correct fair market values and adjusted bases of the assets received in liquidation of Booth are set forth in paragraphs 10 and 11, respectively.

18. In addition to incorrectly determining Herald's adjusted basis in the assets received in the liquidation of Booth, the Service arbitrarily, capriciously and erroneously determined (a) that "going concern value" is an asset without a determinable useful life, and therefore is not subject to the allowance for depreciation, and (b) that newspaper subscribers is an asset without a determinable useful life, and therefore is not subject to the allowance for depreciation.

19. As a result of the errors stated above, the Service erroneously and unlawfully assessed and collected an incorrect amount of tax against Herald for tax years 1977, 1978, 1979, and 1980.

COUNT I

Taxable Year: January 1 through December 31, 1977

20. Morning Ledger hereby incorporates by reference the allegations contained in paragraphs 1 through 19 of the Complaint.

21. Herald timely filed with the Service its federal income tax return (Form 1120) for its taxable year beginning January 1, 1977 and ending December 31, 1977 ("1977 Taxable Year"). The return showed a tax liability of $5,772,428, which amount was fully paid by Herald. Herald subsequently filed an amended federal income tax return (Form 1120X) for its 1977 Taxable Year showing an additional tax liability of $5,069, which was fully paid by Herald. On or about December 24, 1986, Herald paid an additional assessment with respect to the 1977 Taxable Year in the amount of $3,780,889, plus $5,355,346 in interest, or a total amount of $9,136,235. All assessments of tax and interest made with respect to plaintiff's 1977 Taxable Year have been paid in full.

22. By a series of agreements (Form 872) pursuant to section 6501(c)(4) of the Code, the limitations period in which to assess a deficiency in tax with respect to Herald's 1977 Taxable Year was extended to June 30, 1987, and the period in which a claim for refund could be filed with respect to that year was extended for 6 months thereafter, to December 31, 1987.

23. On October 27, 1987, Morning Ledger, as successor to Herald, filed a timely claim for refund (Form 1120X)

for its 1977 Taxable Year. A true and correct copy of this claim for refund is attached hereto as Exhibit A and incorporated herein by reference.

24. More than six months has passed since the date of filing the claim for refund set forth in the previous paragraph.

25. Morning Ledger is entitled to a refund in the amount of $10,454,272 for income taxes and interest paid for its 1977 Taxable Year based upon erroneous valuations, determinations, adjustments and allocations as described in the foregoing paragraphs. The failure of the Service to allow this claim for refund is arbitrary, capricious and unlawful.

26. By virtue of the facts set forth above, defendant is legally indebted to Morning Ledger in the amount of $10,454,272 for federal income taxes and interest paid thereof erroneously, unlawfully and wrongfully assessed and collected for the 1977 Taxable Year or such greater amount as legally may be refundable, plus interest as provided by law, and Morning Ledger is justly entitled to such amount which is due and owing from defendant.

COUNT II

Taxable Year: January 1 through December 31, 1978

27. Morning Ledger hereby incorporates by reference the allegations contained in paragraphs 1 through 19 of the Complaint.

28. Herald timely filed with the Service its federal income tax return (Form 1120) for its taxable year beginning January 1, 1978 and ending December 31, 1978 ("1978 Taxable Year"). The return showed a tax liability of $14,002,575, which amount was fully paid by Herald. Herald subsequently filed an amended federal income tax return (Form 1120X) for its 1978 Taxable Year claiming a refund of $333,413, which amount was

reduced by $5,069 to offset additional tax liability of Herald for its previous year. On November 14, 1986, Herald filed with the Service a waiver of notice of disallowance (Form 2297) with respect to this claim for refund. On or about December 24, 1986, Herald paid an additional assessment with respect to the 1978 Taxable Year in the amount of $3,131,205 in tax, plus $4,124,931 in interest, or a total of $7,246,136. All assessments of tax and interest made with respect to the 1978 Taxable Year have been paid in full.

29. By a series of agreements (Form 872) pursuant to section 6501(c)(4) of the Code, the limitations period in which to assess a deficiency in tax with respect to Herald's 1978 Taxable Year was extended to June 30, 1987, and the period in which a claim for refund could be filed was extended for a period of 6 months thereafter, to December 31, 1987.

30. On October 27, 1987, Morning Ledger, as successor to Herald, filed a timely claim for refund (Form 1120X) for the 1978 Taxable Year. A true and correct copy of this claim for refund is attached hereto as Exhibit B and incorporated herein by reference.

31. More than six months has passed since the date of filing the claim for refund set forth in the previous paragraph.

32. Morning Ledger is entitled to a refund in the amount of $8,192,314 for income taxes and interest paid with respect to its 1978 Taxable Year based upon erroneous valuations, determinations, adjustments and allocations as described in the foregoing paragraphs. The failure of the Service to allow this claim for refund is arbitrary, capricious and unlawful.

33. By virtue of the facts set forth above, defendant is legally indebted to Morning Ledger in the amount of $8,192,314 for federal income taxes and interest erroneously, unlawfully and wrongfully assessed and collected

for the 1978 Taxable Year, or such greater amount as legally may be refundable, plus interest as provided by law, and Morning Ledger is justly entitled to such amount which is due and owing from defendant.

COUNT III

Taxable Year: January 1 through December 31, 1979

34. Morning Ledger hereby incorporates by reference the allegations contained in paragraphs 1 through 19 of the Complaint.

35. Herald timely filed with the Service its federal income tax return (Form 1120) for its taxable year beginning January 1, 1979 and ending December 31, 1979 ("1979 Taxable Year"). The return showed a tax liability of $10,014,729, which amount was fully paid by Herald. On or about December 24, 1986, Herald paid an additional assessment of tax in the amount of $3,786,791, plus assessed interest in the amount of $4,557,838, or a total payment of $8,344,629. All assessments of tax and interest with respect to the 1979 Taxable Year have been paid in full.

36. By a series of agreements (Form 872) pursuant to section 6501(c)(4) of the Code, the limitation period in which to assess a deficiency in tax with respect to Herald's 1979 Taxable Year was extended to June 30, 1987, and the period in which a claim for refund could be filed was extended for an additional 6 months thereafter, to December 31, 1987.

37. On October 27, 1987, Morning Ledger, as successor to Herald, filed a timely claim for refund (Form 1120X) for the 1979 Taxable Year. A true and correct copy of this claim for refund is attached hereto as Exhibit C and incorporated hereinby by reference.

38. More than six months has passed since the date of filing the claim for refund set forth in the previous paragraph.

39. Morning Ledger is entitled to a refund in the amount of $8,576,523 for income taxes and interest paid for its 1979 Taxable Year based upon erroneous valuations, determinations, adjustments and allocations as described in the foregoing paragraphs. The failure of the Service to allow this claim for refund is arbitrary, capricious and unlawful.

40. By virtue of the facts set forth above, defendant is legally indebted to Morning Ledger in the amount of $8,576,523 for federal income taxes and interest erroneously, unlawfully and wrongfully assessed and collected for the 1979 Taxable Year, or such greater amount as legally may be refundable, plus interest as provided by law, and Morning Ledger is justly entitled to such amount which is due and owing from defendant.

COUNT IV

Taxable Year: January 1 through December 31, 1980

41. Morning Ledger hereby incorporates by reference the allegations contained in paragraphs 1 through 19 of the Complaint.

42. Herald timely filed with the Service its federal income tax return (Form 1120) for its taxable year beginning January 1, 1980 and ending December 31, 1980 ("1980 Taxable Year"). The return showed a tax liability of $9,425,510, which amount was fully paid by Herald. On or about December 24, 1986, Herald paid an additional assessment of tax with respect to the 1980 Taxable Year in the amount of $3,576,546, plus assessed interest in the amount of $3,626,369, or a total payment of $7,202,915. All assessments of tax and interest made with respect to Herald's 1980 Taxable Year have been paid in full.

43. By a series of agreements (Form 872) pursuant to section 6501(c)(4) of the Code, the limitations period in which to assess a deficiency in tax for Herald's 1980

Taxable Year was extended to June 30, 1987, and the period in which a claim for refund could be filed was extended for an additional 6 months thereafter, to December 31, 1987.

44. On October 27, 1987, Morning Ledger, as successor to Herald, filed a timely claim for refund (Form 1120X) for the 1980 Taxable Year. A true and correct copy of this claim for refund is attached hereto as Exhibit D and incorporated herein by reference.

45. More than six months has passed since the date of filing the claim for refund set forth in the previous paragraph.

46. Morning Ledger is entitled to a refund in the amount of $7,516,313 for income taxes and interest paid for its 1980 Taxable Year based upon erroneous valuations, determinations, adjustments and allocations as described in the foregoing paragraphs. The failure of the Service to allow this claim for refund is arbitrary, capricious and unlawful.

47. By virtue of the facts set forth above, defendant is legally indebted to Morning Ledger in the amount of $7,516,313 for federal income taxes and interest erroneously, unlawfully and wrongully assessed and collected for the 1980 Taxable Year or such greater amount as legally may be refundable, plus interest as provided by law, and Morning Ledger is justly entitled to such amount which is due and owing from defendant.

* * * * *

48. Herald was, and Morning Ledger as successor to Herald is, the sole and absolute owner of the claims presented herein, and there has never been an assignment or transfer of any of these claims, or any part thereof. No action on any of these claims has been taken by defendant or by any agency thereof other than the actions of the Service as described herein. No other suit or process on this claim is pending in any other court.

WHEREFORE, Morning Ledger demands judgment on COUNTS I, II, III and IV against the United States of America, as follows:

	Refund
COUNT I:	$10,454,272
COUNT II:	$ 8,192,314
COUNT III:	$ 8,576,523
COUNT IV:	$ 7,516,313
Total	$34,739,422

or such greater amount to which Morning Ledger may be entitled, together with interest, as provided by law, on the amount owed under each count, and the costs and expenses, including attorneys' fees, of this action and such further relief as the Court may deem just and proper.

Respectfully submitted,

/s/ Donald A. Robinson
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Dated: November 9, 1988

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(Exhibits Omitted in Printing)

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

(Title Omitted in Printing)

ANSWER

Defendant, the United States of America, through its attorneys, hereby answers the complaint as follows:

1. The Defendant currently lacks knowledge or information sufficient to form a belief as to whether the Plaintiff was incorporated under the laws of New Jersey, but it admits the remaining allegations contained in the paragraph.

2. The Defendant admits that this Court has jurisdiction pursuant to 28 U.S.C. § 1346(a)(1) but denies that the tax at issue was erroneously or illegally assessed and collected by the Internal Revenue Service.

3. The Defendant admits the allegations contained in the paragraph.

4. The Defendant admits the allegations contained in the first four sentences and in the sixth sentence of the paragraph, except that it denies that any of the subject determinations were erroneous. The Defendant denies the remainder of the allegations contained in the paragraph.

5-7. The Defendant currently lacks knowledge or information sufficient to form a belief as to the truth of the allegations of these paragraphs.

8. The Defendant admits that on May 31, 1977, Booth was liquidated by merger into Herald. The Defendant currently lacks knowledge or information sufficient to form a belief as to the truth of the remainder of the allegations of the paragraph.

9. The Defendant currently lacks knowledge or information sufficient to form a belief as to the truth of the allegations of the paragraph.

10-11. The Defendant denies the allegations contained in these paragraphs.

12. The Defendant admits the allegations contained in the first sentence of the paragraph. The Defendant denies the remainder of the allegations contained in the paragraph.

13-19. The Defendant denies the allegations contained in these paragraphs.

20. The Defendant incorporates by reference the answers to paragraphs 1 through 19 as set forth above.

21. The Defendant admits the allegations contained in the second and fourth sentences of the paragraph. The defendant denies that Herald's income tax return was timely filed but admits to the remainder of the allegations contained in the first sentence of the paragraph. The Defendant denies that the $5,069 was fully paid by Herald but admits to the remainder of the allegations contained in the third sentence of the paragraph. The defendant denies the allegations contained in the last sentence of the paragraph.

22. The Defendant admits the allegations contained in the paragraph.

23. The Defendant admits the allegations contained in the paragraph, except that the Defendant denies that the claim for refund was filed on October 27, 1987. The Defendant would admit that the claim for refund was filed on October 28, 1987.

24. The Defendant admits the allegations contained in the paragraph.

25-26. The Defendant denies the allegations contained in these paragraphs.

27. The Defendant incorporates by reference the answers to paragraphs 1 through 19 as set forth above.

28. The Defendant denies that Herald, as alleged in the first sentence of the paragraph, timely filed its federal tax return for the taxable year ending December 31, 1978 but would admit that the return was timely filed pursuant to an extension of the filing deadline to September 15, 1979. The Defendant denies that Herald, as alleged in the third sentence of the paragraph, claimed a refund in its amended federal income tax return for its 1978 Taxable Year of $333,413 but would admit that Herald claimed a refund of $338,413. The Defendant denies that Herald, as alleged in the fifth sentence of the paragraph, paid an additional assessment with respect to the 1978 Taxable Year of $3,131,205 but would admit that Herald paid an additional assessment of $3,121,205. The Defendant admits the remainder of the allegations contained in the paragraph.

29. The Defendant admits the allegations contained in the paragraph.

30. The Defendant admits the allegations contained in the paragraph, except that it denies that the claim for refund was filed on October 27, 1987. The Defendant would admit that the claim for refund was filed on October 28, 1987.

31. The Defendant admits the allegations contained in the paragraph.

32-33. The Defendant denies the allegations contained in these paragraphs.

34. The Defendant incorporates by reference the answers to paragraphs 1 through 19 as set forth above.

35. The Defendant denies that Herald timely filed its income tax retuurn for the taxable year ending December 31, 1979 but would admit that the return was timely

filed pursuant to an extension of the filing deadline to September 15, 1980. The Defendant admits the remainder of the allegations contained in the paragraph.

36. The Defendant admits the allegations contained in the paragraph.

37. The Defendant denies that Herald filed its claim for refund for the 1979 Taxable Year on October 27, 1987 but would admit that Herald filed its claim on October 28, 1987. The Defendant admits the remainder of the allegations contained in the paragraph.

38. The Defendant admits the allegations contained in the paragraph.

39-40. The Defendant denies the allegations contained in these paragraphs.

41. The Defendant incorporates by reference the answers to paragraphs 1 through 19 as set forth above.

42. The Defendant denies that Herald timely filed its federal income tax return for the taxable year ending December 31, 1980 but would admit that the return was filed timely pursuant to an extension of the filing deadline to September 15, 1981.

43. The Defendant admits the allegations contained in the paragraph.

44. The Defendant denies that Herald filed its claim for refund for the 1980 Taxable Year on October 27, 1987 but would admit that Herald filed its claim on October 28, 1987. The Defendant admits the remainder of the allegations contained in the paragraph.

45. The Defendant admits the allegations contained in the paragraph.

46-47. The Defendant denies the allegations contained in these paragraphs.

48. The Defendant admits that no action on any of these claims has been taken by the Defendant or by any agency thereof other than the actions of the Service as described in the Complaint. The Defendant denies the remainder of the allegations contained in the paragraph.

Wherefore, the Defendant prays that judgment be entered in its favor and that this Court issue an order dismissing the complaint and awarding defendant its costs and such further relief as this Court may deem just and proper.

Respectfully submitted,

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United States Attorney

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(Certificate of Service Omitted in Printing)

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

(Title Omitted in Printing)

PLAINTIFF'S ANSWERS AND OBJECTIONS TO DEFENDANT'S INTERROGATORIES TO PLAINTIFF

* * * *

Interrogatory No. 9:

For each publication listed in the Answer to Interrogatory No. 7, (a) please describe the method used to circulate the newspapers, including but not limited to a description of the working relationships between the publication, its circulation department, the distributors and carriers and the methods they used to deliver the publications, paying particular attention to the way that the subscription lists were used and by whom to deliver the publications.

(b) In particular, for each of the publications, identify whether each of the entities in the circulation chain were employees of the publication or whether any were independent contractors.

(c) What contractual relationships existed between each publication and those who had possession of or access to its subscription lists.

Answer to Interrogatory No. 9:

1. Ann Arbor News

The circulation department of The Ann Arbor News consisted of a circulation manager, district managers and office staff, full-time and part-time, all of whom were employees of The Ann Arbor News.

The circulation manager oversaw the entire circulation department and the mailroom. The district managers each were assigned a geographic area in which they were responsible for dealing with about 125 carriers. It was the district manager's responsibility to contract with new carriers as needed, to make sure carriers paid their paper bills in a timely manner, and to encourage new sales through carrier contests and crew canvassing with their carriers. The office staff kept the department books and answered the telephones when either customers or carriers called with complaints or, in the case of carriers, to change the number of papers they needed.

Newspapers were transported to foot carriers and single copy locations from the plant dock area by several operator-owned pick-up trucks, all of whom were independent contractors.

Foot carriers, usually youngsters, would pick up their papers from their drops and then deliver to their individual customers on their paper routes. All foot carriers were independent contractors.

Adult motor carriers, all of whom were independent contractors, also picked up their papers from the dock area and then proceeded to deliver to their individual customers.

The contracts stated that subscription lists were the property of The Ann Arbor News. A carrier was required to turn in a list to the paper once a year, usually in February, or when the carrier went off his route. At all other times the carrier kept his own delivery list and informed the paper when he needed more or fewer papers to deliver to the customers.

2. Bay City Times

The Bay City Times had an employee staff of four district managers reporting to the circulation manager. Two district managers were assigned to the state area

supervising state and county motor route operators, agents and bundle haulers. The other two were assigned to supervise city carriers for city home delivery.

State motor route bundles were delivered by independent contract haulers to pick up sites in the state area. Bay County motor route operators picked up their bundles at the mailroom dock. City carrier bundles were delivered by Times-operated trucks and part-time employees (truck drivers).

Motor route operators and foot carriers were independent contractors, operating their own vehicles and delivering to individual subscribers and single copy outlets. Three motor route operators acted as distributors in Gaylord, West Branch and Tawas City and provided carrier home delivery in their respective cities, as well as covering the balance of their areas as regular motor routes.

Subscriber lists were maintained by each motor route operator and carrier for delivery and collection purposes. The newspaper was provided with a subscriber list whenever a carrier change was made, and then the newspaper provided the list to the new carrier.

The agreements with one or more of the special distributors identified above provided that the subscriber list for his area was the property of the distributor; however, the list was to be provided to The Times upon termination of the agreement.

3. Flint Journal

The Journal was delivered via Newspapers Deliveries, Inc. to carriers for conveyance to subscribers. Two types of contracts existed between the newspaper and these parties: one that governed the relationship between Newspapers Deliveries, Inc. and The Flint Journal, and the other between The Journal and the carriers. The former did not have any reference to subscriber lists, but instead referred to bundle identification, showing where the bulk

papers were to be dropped. The latter contracts provided that the subscriber lists were the property of The Journal, and were provided by The Journal to the carriers for delivery purposes only.

One type of motor route delivery was a mirror copy of the carrier delivery arrangement described above whereby Newspapers Deliveries, Inc. provided bundle drops to motor route agents. Another type of motor route delivery provided for conveyance of the newspapers directly to the motor route driver at The Journal's dock. In both cases, motor route drivers were governed by the same type of contract as the carriers, which is described above. Ownership of the subscriber list, used for delivery by the driver, remained the property of The Flint Journal.

Street sales were made by street sale agents, who were contractees under a separate agreement with The Journal. These were single copy sales; therefore, no subscriber list existed, other than a record of the locations of the boxes/sales. That information was referenced in the contract as belonging to The Journal.

Newspapers Deliveries, Inc. delivered bundles to newsstand locations for sale to the public as single copies. Newspapers Deliveries, Inc. was under contract for this delivery. No contract existed between the Journal and the newsstand sellers. Newspapers Deliveries, Inc. delivered bundles to schools for use in the classroom. No contract existed between the Journal and the schools, and no subscriber list was applicable.

Newspapers Deliveries, Inc. delivered sacks to the post office for delivery to mail subscribers who dealt directly with The Journal. The Journal maintained a complete address list of all of these subscribers.

The Journal had office-collect customers who paid The Journal directly for their subscription. A complete list of these customers was maintained by the newspaper. In turn, The Journal hired Newspapers Deliveries, Inc. to

deliver these papers every day directly to the subscribers homes. Additionally, employees of The Journal sold single copies directly to the walk-in public in the building lobby.

4. Grand Rapids Press

The Grand Rapids Press was delivered by carriers, motor route drivers and the U.S. mail. It was also sold through newsstands and vending machines. All of these methods of delivery, except the U.S. mail, were handled through a contractual agreement between The Press and the individuals involved. Circulation department members were employees of The Grand Rapids Press.

Under the agreements, subscriber lists were the property of The Press, and were provided to the carriers and motor route drivers by The Press for delivery purposes only and could not be used for any other purpose without the consent of The Grand Rapids Press. The lists had to be returned to The Press at the termination of the contract.

5. Jackson Citizen Patriot

The Patriot was delivered by motor route and carrier delivery. All motor route drivers and carriers were independent contractors.

The carriers generated handwritten lists which would be passed on to succeeding carriers, either in written form or by walking the route with the new carrier. The city carriers would often have a non-subscriber list, because such a list was easier to maintain. In either case, the list was maintained by the carrier, and provided periodically to the newspaper. The Patriot was further provided with a subscriber list whenever a carrier change was made, and then the Patriot provided the list to the new carrier.

The paper also had a total market coverage product (called the News Advertiser) delivered by independent contractors. Consultation between the district manager and the carrier produced a "route list" for that product, which was then kept and maintained by the carrier.

6. Kalamazoo Gazette

The Kalamazoo Gazette was delivered by carriers, motor route drivers and the U.S. mail. It was also sold through newsstands and vending machines. All of these methods of delivery, except the U.S. mail, were handled through a contractual agreement between The Kalamazoo Gazette and the individuals involved. Circulation department members were employees of the Kalamazoo Gazette.

Under the agreements, subscriber lists were the property of the Gazette, and were provided to the carriers and motor route drivers for delivery purposes only and could not be used for any other purpose without the consent of The Kalamazoo Gazette. The lists had to be returned to The Gazette at the termination of the contract.

7. Muskegon Chronicle

The Chronicle was distributed primarily through a system of youth carriers. There were 30-40 motor routes in rural areas and 5-6 adult carriers. All other delivery was by youth carriers. All carriers were independent contractors. In the late 1970's, two distributors were utilized in Muskegon Heights, each of whom controlled distribution of about 700 papers each.

Both The Chronicle and carriers had route lists. The lists were the property of The Chronicle. The carriers had the responsibility to update the lists periodically.

8. Saginaw News

The distribution force for The News consisted almost entirely of independent contractors, either youth carriers, adult motor route drivers, or adult agents within the City of Saginaw. In all cases, The News was sold wholesale to these individuals and they were responsible for the distribution of the paper and the collection of money from subscribers.

Subscriber lists were maintained and utilized by both the independent contractors and the Circulation Department. The independent contractors used the lists to determine to whom they should deliver the paper. The Circulation Department periodically checked the lists against newspaper draws to determine that the contractors were getting the proper number of papers. The agreements with the independent contractors provided that the subscriber lists were the property of The News, and were provided by The News to the carriers for delivery purposes only.

Within the City of Saginaw, part-time employees of the paper handled news racks. They were responsible for distribution, collecting the boxes, and bringing in returns. Also, counter sales and mail subscriptions were handled by employees.

The distribution force received their papers in one of two ways. All of the carriers and some of the motor routes had their papers delivered to drop-off points. Some motor route drivers came to The Saginaw News and picked up their papers.

The distribution function at The News reported to the Production Manager who, in turn, reported to the Publisher. The Circulation Department was responsible for all the independent contractors, making sure their draws were adjusted, bills were paid, and that service complaints were passed on to the appropriate contractor. The Circulaton Manager reported directly to the Publisher.

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UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

(Title Omitted in Printing)

FINAL PRETRIAL ORDER

This matter having come before the Court for a pretrial conference pursuant to Fed. R. Civ. P. 16; Donald A. Robinson, having appeared for the plaintiff and Gregory S. Hrebiniak having appeared for defendant; the following Final Pretrial Order is hereby entered:

1. JURISDICTION—This Court has jurisdiction pursuant to 28 U.S.C. § 1346(a)(1).

2. PENDING/CONTEMPLATED MOTIONS

Plaintiff's Motion for Leave to Amend the Complaint to Conform Allegations of Value and Damages to the Evidence Presented at the Trial (as summarized in Item 4 of this Order). Such a motion may be appropriate at the conclusion of the trial, and, if such a motion is appropriate, it will be promptly submitted by Plaintiff at that time.

Defendant contemplates no pretrial motions other than those associated with the testimony of Donald E. Newhouse and Werner Veit as more fully discussed below.

3. STIPULATION OF FACTS

a. Plaintiff, Newark Morning Ledger Co. ("Morning Ledger") is a corporation organized and existing under the laws of the State of New Jersey, having its principal place of business in Newark, New Jersey.

b. Morning Ledger is the successor to The Herald Company ("Herald") which was liquidated by merger into Morning Ledger on June 30, 1987 in a transaction governed by Sections 332 and 334(b)(1) of the Internal Revenue Code of 1954 (the "Code"). For many years prior to June 30, 1987, both corporations were engaged in the business of publishing daily and Sunday newspapers. Morning Ledger continues to be so engaged.

c. Herald was the transferee of the assets of Booth Newspapers, Inc. ("Booth") which was liquidated by merger into Herald on May 31, 1977 in a transaction governed by Sections 332 and 334(b)(2) of the Code as then in effect. Immediately prior to its liquidation, Booth was a Michigan corporation engaged in the publication of the following daily and Sunday newspapers of general circulation in eight Michigan communities: Ann Arbor News, Bay City Times, Flint Journal, Grand Rapids Press, Jackson Citizen Patriot, Kalamazoo Gazette, Muskegon Chronicle and Saginaw News. Booth's wholly owned subsidiary, Parade Publications, Inc. ("Parade"), published *Parade*, a nationally distributed Sunday newspaper supplement.

d. In this action, Morning Ledger has claimed a refund of taxes and deficiency interest collected from it by the Defendant in the following amounts and for the following calendar and taxable years:

Year	Tax	Interest
1977	$5,098,926	$5,355,346
1978	$4,067,383	$4,124,931
1979	$4,018,685	$4,557,838
1980	$3,889,944	$3,626,369

At the time of the preparation of the pretrial order, the trial attorneys for the parties have reached a tentative partial settlement on all of the pending issues except those associated with the depreciation of intangible assets

referred to as "paid subscribers" by Morning Ledger, as is more fully set forth below. The terms of the settlement are memorialized in a written agreement prepared by Morning Ledger and submitted to the Department of Justice. Because of the amounts of the refunds of tax generated by the settlement, the proposal must be reviewed and approved by a hierarchy established by government regulation which may include the Congressional Joint Committee on Taxation. However, the remainder of the pretrial order is being prepared in anticipation of such approval.

e. In total, Herald paid $304,680,145 or $41.44 per share for all of the stock of Booth. Acquisition costs associated with the purchase totalled $2,878,311, giving Herald an adjusted cost basis of $307,558,456 in the Booth stock.

f. Herald's adjusted cost basis in the assets distributed on May 31, 1977 in liquidation of Booth is alleged to be $328,173,154 as agreed upon in the tentative partial settlement described in ¶ 3 d, *supra*.

g. The assets acquired by Herald in the liquidation of Booth were of three types: (1) cash, cash equivalents and other financial assets including securities, accounts and notes receivable and deferred charges and deposits; (2) tangible and intangible assets of the Booth newspaper operations, including land, land improvements, buildings, equipment, furniture, fixtures and vehicles, computer software, going concern and goodwill; and (3) stock of Parade Publications, Inc., a wholly owned subsidiary. In addition, Morning Ledger asserts Herald acquired paid newspaper subscribers as intangible assets. Defendant disputes that paid newspaper subscribers are intangible assets separate and apart from goodwill.

h. On May 31, 1977, the fair market values and adjusted tax bases of certaian of the assets acquired in the liquidation of Booth were as follows (as agreed upon in the tentative partial settlement described in ¶ 3d, *supra*):

Assets	Value	Basis
Cash and Equivalents	$ 15,617,042	$ 15,617,042
Securities	$ 37,249,852	$ 39,134,189
Accounts and Notes Receivable	$ 15,046,899	$ 15,046,899
Master Repurchase Agreements	$ 3,100,000	$ 3,100,000
Deferred Charges and Deposits	$ 323,944	$ 340,311
Inventories	$ 3,435,627	$ 3,609,423
Land	$ 4,658,885	$ 4,894,561
*Land Improvements	$ 1,721,959	$ 1,809,067
*Buildings & Improvements	$ 21,350,237	$ 22,430,269
*Production Equipment	$ 17,109,130	$ 17,974,620
*Computer Hardware	$ 1,300,435	$ 1,366,219
*Furniture and Fixtures	$ 880,775	$ 925,330
*Office Equipment	$ 731,195	$ 768,184
*Autos and Trucks	$ 234,489	$ 246,351
*Computer Software	$ 1,658,000	$ 1,741,872
Stock of Parade	$100,000,000	$105,058,644

* See ¶ 3 1, *infra*.

i. Also included among the assets of Booth distributed to Herald on May 31, 1977 were certain intangible assets, to wit: the going concern value and goodwill of the papers as well as the disputed assets, the paid subscribers of each of the Booth newspapers. On May 31, 1977, the total value and the aggregate tax basis of these assets were $89,578,685 and $94,110,152, respectively, as agreed upon in the tentative partial settlement described in ¶ 3 d, *supra*. The factual determination before the Court is the degree, if any, to which the paid subscribers of the Booth newspapers constitute assets separate and apart from goodwill; and, if so, the value of such assets. To the extent the Court find the paid subscribers of the Booth newspapers have a value separate and apart from goodwill, that value is part of the $89,578,685 and $94,110,152 in total value and aggregate tax basis, respectively, as agreed upon in the tentative partial settlement described in ¶ 3 d, *supra*.

j. The paid subscribers of the Booth newspapers consisted of the customers who had arranged to have one of the Booth newspapers delivered to their homes by mail or

by carrier. On May 31, 1977, the number of paid subscribers of each of the Booth newspapers was as follows:

PAPER	DAILY	SUNDAY
Ann Arbor	37,743	37,121
Bay City	37,337	36,255
Flint	91,366	91,155
Grand Rapids	120,011	106,859
Jackson	35,711	35,632
Kalamazoo	51,481	52,960
Muskegon	41,203	40,609
Saginaw	49,327	48,942

The name and address of each paid subscriber was retained by Booth and/or its circulation employees, agents and/or contractors. The methods of circulation of each of the Booth newspapers is more fully set forth in Morning Ledger's answer to Interrogatory No. 9 which is incorporated in this stipulation.

k. The parties have agreed that, if the Court determines that the paid subscribers of each of the Booth newspapers constitute assets separate and apart from goodwill, and with values which can be ascertained separate and apart from goodwill, and if the Court determines that the paid subscribers of each of the Booth newspapers have useful lives that could be estimated with reasonable accuracy, then the paid subscribers of the Booth newspapers can be amortized or depreciated on a straight-line basis over the following useful lives:

Newspaper	Useful Lives of Daily Subscribers	Useful Lives of Sunday Subscribers
Ann Arbor	14.7	14.7
Bay City	22.2	23.4
Fint	18.3	18.5
Grand Rapids	17.7	21.2
Jackson	17.9	18.9
Kalamazoo	17.0	17.6
Muskegon	18.0	16.2
Saginaw	17.4	18.3

1. For the taxable years 1977-80, the tentative partial settlement recognizes that Herald was entitled to deductions for depreciation or amortization with respect to certain assets acquired in the liquidation of Booth, specifically those assets designated by asterisk in ¶ 3 h, in addition to amounts allowed by the Commissioner of Internal Revenue. Further, during the taxable years 1977, 1978, and 1979, Herald sold certain assets acquired in the liquidation of Booth. Based solely upon the increased cost basis for those assets, as recognized by the tentative partial settlement, as set forth in ¶ 3 h *supra*, Herald's gain on such sales was less than the amounts determined by the Commissioner of Internal Revenue. Finally, solely as a result of the increased deductions and decrease in taxable income as recognized by the tentative partial settlement, Herald's tax liability for the years 1977, 1978, 1979 and 1980 is decreased. Morning Ledger has submitted its calculation as to the amounts of refunds due for 1977 through 1980, and the defendant is verifying the calculations to be finalized only upon final approval of the tentative partial settlement.

m. Morning Ledger timely filed claims for refund asserting a right to the deductions and reduced income claimed in this proceeding.

n. Morning Ledger has not received any credit or refund of all or any part of the taxes set forth in its claims for refund, and at the time of the filing of this suit, the said claims had been denied, or more than six months had passed since they had been filed. The parties agree that a recomputation by the Internal Revenue Service at the conclusion of trial must be performed to verify any amounts due Morning Ledger.

o. Morning Ledger timely filed its complaint in this action.

4. PLAINTIFF'S CONTESTED FACTS

To the extent they constitute contested facts, Morning Ledger intends to prove the following with regard to liability and damages:

a. The paid subscribers of the Booth newspapers were assets with limited useful lives which could be estimated with reasonable accuracy.

b. Morning Ledger's expert, Dr. Gerald J. Glasser, conducted a study of the paid subscribers of the Booth newspapers as of May 1977, and concluded that the remaining lives of those subscribers, and the nature and rate of decay of those subscribers, could be determined with reasonable accuracy.

c. The paid subscribers of the Booth newspapers were assets that could be identified and valued separate and apart from goodwill.

d. Morning Ledger's experts, Larry D. Berkey of Touche Ross & Co. and Roger J. Grabowski of Price Waterhouse & Co. properly determined the fair market values of the paid subscribers of the Booth newspapers as of May 31, 1977. These values are as follows:

1. Valuation Engineering Associates, a business unit of Touche Ross & Co., "Booth Newspapers Fair Market Value Paid Subscribers as of May 31, 1977" dated November 3, 1989:

Newspaper		Fair Market Value
Ann Arbor News	-daily	$ 3,594,000
	-Sunday	517,000
Bay City Times	-daily	4,799,000
	-Sunday	703,000
Flint Journal	-daily	13,119,000
	-Sunday	1,702,000

Newspaper		Fair Market Value
Grand Rapids Press	-daily	12,104,000
	-Sunday	1,679,000
Jackson City Patriot	-daily	4,248,000
	-Sunday	651,000
Kalamazoo Gazette	-daily	6,074,000
	-Sunday	957,000
Muskegon Chronicle	-daily	4,688,000
	-Sunday	604,000
Saginaw News	-daily	5,881,000
	-Sunday	899,000
	Total	$62,219,000

2. Price Waterhouse & Co., "Fair Market Value Study of Paid Newspaper Subscribers to Booth Newspapers as of May 31, 1977" dated October 25, 1989:

Newspaper		Fair Market Value
Ann Arbor News	-daily	$ 3,131,081
	-Sunday	508,484
Bay City Times	-daily	4,870,995
	-Sunday	812,136
Flint Journal	-daily	12,162,206
	-Sunday	2,025,377
Grand Rapids Press	-daily	11,954,936
	-Sunday	1,878,596
Jackson City Patriot	-daily	3,916,261
	-Sunday	660,387
Kalamazoo Gazette	-daily	5,775,600
	-Sunday	1,013,675
Muskegon Chronicle	-daily	4,641,033
	-Sunday	721,501
Saginaw News	-daily	5,730,095
	-Sunday	971,582
	Total	$60,773,945

Based upon the stipulation set forth in ¶ 3 k, *supra*, which was only reached on December 13, 1989, Messrs. Berkey and Grabowski may prepare supplemental tables making revisions to the above

numbers. If such supplemental tables are to be presented in the trial of this matter, they will be promptly provided to defendant's counsel and the Court as soon as they are available.

e. Based on the foregoing fair market values and the determination of the limited useful lives of the paid subscribers of the Booth newspapers, Morning Ledger claims entitlement to additional deductions for depreciation or amortization of those paid subscribers. These figures are currently being computed based upon the stipulation set forth in ¶ 3 k, *supra*. They will be provided to defendant's counsel and the Court as soon as they are available.

f. Based on the deductions set forth in ¶ 4 f, Plaintiff claims refunds in income tax and deficiency interest. These figures are currently being computed based upon the stipulation set forth in ¶ 3 k, *supra*. They will be provided to defendant's counsel and the Court as soon as they are available.

5. DEFENDANT'S CONTESTED FACTS

Defendant intends to prove the following contested facts with regard to liability and damages:

a. There is no asset separate and apart from goodwill entitled "paid newspaper subscribers" and the concept intended to be conveyed by the title "paid newspaper subscribers" has no limited useful life which could be estimated with reasonable accuracy.

b. The only asset traditionally recognized as consistent with plaintiff's concept of "paid newspaper subscribers" is the "subscriber lists" of the subscribers to each of the Booth newspapers. Such lists were in several instances not even the property of nor were they in the possession of the purchased newspapers.

c. To the extent that the "subscriber lists" could be valued at all, Joseph Baniewicz of the Internal Revenue Service has determined a cost replacement value of all the lists to be $2,296,763.

d. To the extent that "subscriber lists" could be valued at all, Shenkin, Kurtz, Baker & Co. has determined a cost value of $1,250,000. However, both Mr. Baniewicz and Mr. Shenkin agree that newspaper subscription lists or "paid newspaper subscribers" have no market value separate and apart from the operation of a newspaper.

e. Newspaper subscription lists or "paid newspaper subscribers" have no determinable useful life.

f. Dr. Shien Perng of the Internal Revenue Service has determined that plaintiff's method of determining the average life is incorrect and that the determination does not arrive at an acceptable useful life.

g. Plaintiff is not entitled to any additional deductions for depreciation or refunds of tax and deficiency interest based on the treatment of "paid subscribers" or subscription lists.

6. PLAINTIFF'S WITNESSES

a. On liability and damages Morning Ledger intends to call the following witnesses who will testify in accordance with the following summaries:

Larry D. Berkey, Touche Ross & Co., Metro Park III, 399 Thornall Street, Edison, NJ 08837, 201-906-9600. Mr. Berkey will testify as to the fair market value of the paid subscribers of the Booth newspapers as of May 31, 1977. The primary points of his testimony are summarized by

Plaintiff's Exhibit No. 1, attached hereto. Based upon the stipulation set forth in ¶ 3 k, *supra*, Mr. Berkey may prepare supplemental tables making revisions to the numbers in the exhibit. If such supplemental tables are to be presented in the trial of this matter, they will be promptly provided to defendant's counsel and the Court as soon as they are available.

Gerald J. Glasser, Ph.D., Statistical Research, Inc., 111 Prospect Street, Westfield, New Jersey 07090, 201-654-4000. Dr. Glasser will testify that the remaining lives of the paid subscribers of the Booth newspapers, and the nature and rate of decay of those subscribers, could be determined with reasonable accuracy as of May 31, 1977. The primary points of his testimony are summarized by Plaintiff's Exhibit No. 2, attached hereto.

Roger J. Grabowski, Price Waterhouse & Co., 200 East Randolph Drive, Chicago, IL 60601, 312-565-1500. Mr. Grabowski will testify as to the fair market value of the paid subscribers of the Booth newspapers as of May 31, 1977. The primary points of his testimony are summarized by Plaintiff's Exhibit No. 3, attached hereto. Based upon the stipulation set forth in ¶ 3 k, *supra*, Mr. Grabowski may prepare supplemental tables making revisions to the numbers in the exhibit. If such supplemental tables are to be presented in the trial of this matter, they will be promptly provided to defendant's counsel and the Court as soon as they are available.

Donald E. Newhouse, Newark Morning Ledger Co., 1 Star Ledger Plaza, Newark, N.J. 07101. 201-877-4115. Mr. Newhouse will testify as to the facts surrounding the acquisition of the Booth Newspapers. He will also testify to the market conditions, business operations, competition, circu-

lation efforts, and subscriber characteristics of the Booth newspapers in particular and the newspaper industry in general. Mr. Newhouse has been deposed in lieu of providing an expert report.

Christine Urban, Ph.D., Urban & Associates, Inc., 26 E. Chestnut Street, Sharon, Massachusetts 02067, 617-784-8500. Dr. Urban will testify as to subscriber characteristics, circulation trends of paid daily newspaper, circulation efforts undertaken by newspapers, and the nature and characteristics of paid and free distribution newspapers with respect to the newspaper industry in general and the Booth newspapers in particular. The primary points of her testimony are summarized by Plaintiff's Exhibit No. 4, attached hereto.

Werner Veit, President, Booth Newspapers, Inc., 155 Michigan, N.W., Grand Rapids, MI 49503, 616-459-3817. Mr. Veit will testify as to the market conditions, business operations, competition, circulation efforts, subscriber characteristics of the Booth Newspapers and efforts made to preserve and enhance goodwill. Mr. Veit has been deposed in lieu of providing an expert report.

b. Defendant objects to the following witnesses for the reasons stated:

Defendant denies that the depositions of Donald E. Newhouse and Werner Veit have been substituted in lieu of providing an expert report and would have the Court characterize the two witnesses as fact witnesses. Their testimony as experts should be excluded in accordance with ¶ 10 of the scheduling order of May 15, 1989.*

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* These witnesses limited to answering hypotheticals set forth on pp. 20 and 21 unless, at least 7 business days before trial, experts' reports submitted.

7. DEFENDANT'S WITNESSES

a. On liability and damages defendant intends to call the following witnesses who will testify in accordance with the following summaries:

Joseph P. Baniewicz, Financial Analyst, Internal Revenue Service, Washington, D.C.; Mr. Baniewicz will testify in accordance with his report on the valuation of the subscription lists of May 31, 1977 and as to the accounting and valuation methods used by plaintiff's experts.

Arthur Shenkin, Shenkin, Kurtz, Baker & Co., Englewood, Colorado; Mr. Shenkin will testify in accordance with his report on the valuation of the subscription lists of May 31, 1977 and as to the accounting and variation methods used by plaintiff's experts.

Dr. Shien Perng, Statistician, Internal Revenue Service, Washington, D.C.; Dr. Perng will testify in accordance with his report on the average remaining life of subscriptions to Booth newspapers.

Donald E. Newhouse, Newark Morning Ledger Co., Newark, New Jersey; Mr. Newhouse will testify on the market conditions, business operations, competition, circulation efforts and subcriber characteristics of the Booth newspapers.

Werner Veit, President, Booth Newspapers, Inc., Grand Rapids, Michigan; Mr. Veit will testify as to the market conditions, business operations, competition, circulation efforts and subscriber characteristics of the Booth newspapers.

b. Morning Ledger objects to the following witnesses for the reasons stated:

Morning Ledger objects to Joseph P. Baniewicz on the basis of Mr. Baniewicz's expertise, and on

the basis of the scope and relevance of his testimony. Morning Ledger intends to explore these issues on voir dire, and respectfully reserves the right to make an objection, if appropriate, at that time.

Morning Ledger objects to Arthur F. Shenkin for the reason that Mr. Shenkin lacks expertise to assist the trier of fact. Morning Ledger further objects to Mr. Shenkin's report for the reason that it contains inadmissible legal argumentation and conclusions. Morning Ledger intends to explore these issues on voir dire, and respectfully reserves the right to make an objection, if appropriate, at that time.*

8. EXPERT WITNESSES

a. Morning Ledger's expert witnesses are:

Larry D. Berkey
Touche Ross & Co.
Metro Park III
399 Thornall Street
Edison, NJ 08837
201-906-9600

Gerald J. Glasser, Ph.D.
Statistical Research, Inc.
111 Prospect Street
Westfield, New Jersey 07090
201-654-4000

Roger J. Grabowski
Price Waterhouse & Co.
200 East Randolph Drive
Chicago, IL 60601
312-565-1500

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* These objections to be made at trial.

Donald E. Newhouse
Newark Morning Ledger Co.
1 Star Ledger Plaza
Newark, N.J. 07101
201-877-4115

Christine D. Urban, Ph.D.
Urban & Associates, Inc.
26 E. Chestnut Street
Sharon, Massachusetts 02067
617-784-8500

Werner Veit
President
Booth Newspapers, Inc.
155 Michigan, N.W.
Grand Rapids, Michigan 49503
616-459-3817

b. Defendant's objection to the qualifications of Morning Ledger's expert witnesses are:

Defendant objects to the classification of fact witnesses, Werner Veit and Donald E. Newhouse, as expert witnesses. Messrs. Veit and Newhouse will testify as to factual matters and have not prepared any expert opinions or reports in accordance with this court's scheduling order.

c. Defendant's expert witnesses are:

Joseph P. Baniewicz
Financial Analyst
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224
202-252-8121

Arthur Shenkin
Shenkin, Kurtz, Baker & Co.
5251 DTC Parkway
Englewood, Colorado 80111
303-796-2600

Dr. Shien Perng
Statistical Methods Group
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224
202-376-0203

d. Morning Ledger's objections to the qualifications of defendant's expert witnesses are:

Morning Ledger objects to Joseph P. Baniewicz on the basis of Mr. Baniewicz's expertise, and on the basis of the scope and relevance of his testimony. Morning Ledger intends to explore these issues on voir dire, and respectfully reserves the right to make an objection, if appropriate, at that time.

Morning Ledger objects to Arthur F. Shenkin for the reason that Mr. Shenkin lacks expertise to assist the trier of fact. Morning Ledger further objects to Mr. Shenkin's report for the reason that it contains inadmissible legal argumentation and conclusions. Morning Ledger intends to explore these issues on voir dire, and respectfully reserves the right to make an objection, if appropriate, at that time.

9. PLAINTIFF'S DEPOSITIONS

On liability and damages Morning Ledger does not intend to read any portion of the depositions into evidence.

10. DEFENDANT'S DEPOSITIONS

a. On liability and damages, defendant does not intend to read any portion of the depositions into evidence unless for unforeseen reasons, a witness is unable to testify at trial.

b. Morning Ledger reserves the right to object to any portion of such deposition testimony at the

time it is offered depending on the circumstances upon which it is offered.

11. PLAINTIFF'S EXHIBITS

(Except for exhibits the need for which could not reasonably have been foreseen or which are used solely for impeachment purposes, only the exhibits set forth on the exhibit list attached hereto may be introduced at trial. Any objection to an exhibit, and the reason for said objection, must be set forth below or it shall be deemed waived. All parties hereby agree that it will not be necessary to bring in the custodian of any exhibit as to which no such objection is made.)

a. Morning Ledger intends to introduce into evidence the exhibits listed on the attached exhibit list:

1. Valuation Engineering Assoc., a business unit of Touche Ross & Co., "Booth Newspapers Fair Market Value Paid Subscribers as of May 31, 1977" dated November 3, 1989
2. Statistical Research, Inc., "Report on the Average Remaining Life of Subscriptions to Booth Newspapers" dated March 1978
3. Price Waterhouse & Co., "Fair Market Value Study of Paid Newspaper Subscribers to Booth Newspapers as of May 31, 1977" dated October 25, 1989
4. Urban & Associates, Inc., "An Overview of Paid Daily Newspaper Circulation Trends"
5. The Columbia Flier, v. 8, no. 50, dated June 2, 1977. (Columbia, MD).
6. The Reader, v. 6, no. 34, dated May 27, 1977. (Chicago, IL).

7. The Columbia Flier, v. 21, no. 25, dated November 30, 1989. (Columbia, MD).
8. The Reader, v. 19, no. 11, dated December 8, 1989. (Chicago, IL).

b. Defendant does not object to the authenticity of any of Morning Ledger's exhibits; however, defendant reserves the right to object to the exhibits enumerated as 5-8 on grounds of relevancy and admissibility depending upon the circumstances under which they are offered into evidence.

12. DEFENDANT'S EXHIBITS

a. Defendant intends to introduce into evidence the exhibits listed on the attached exhibit list:

1. The Fair Market Value of the Booth Newspapers Inc's. Subscription Lists as of May 31, 1977, by Joseph Baniewicz.
2. Shenkin, Kurtz, Baker & Co's. Report in Newark Morning Ledger Co. v. United States.
3. Statistical Methods Group's Comments on Report of the Average Remaining Life of Subscriptions to Booth Newspapers.
4. Booth Newspapers, Inc. Fair Market Value by Arthur D. Little Valuation, Inc., dated December 10, 1985.
5. Fair Market Value Study of Booth Newspapers, Inc. for Herald Company as of May 31, 1977, by American Valuation Consultants, dated May 4, 1979.
6. Selected copies of publications listed in the plaintiff's Answer to Interrogatory No. 12 propounded by defendant.
7. Answer to Interrogatory No. 11 propounded to plaintiff by the defendant.

8. Audit Bureau of Circulation Audit Reports on each Booth newspaper.

9. Research Reports prepared by Goldfarb Consultants Limited for the Booth newspapers.

10. Market studies conducted by Market Opinion Research for the Booth newspapers.

11. A market study of the Jackson City Patriot by Gendinning and Associates.

12. Two market studies by Reichman Research, Inc. on the Grand Rapids Press.

b. Morning Ledger does not object to the authenticity of any of defendant's exhibits; however, Morning Ledger reserves the right to object to the exhibits enumerated as 3, 4, 5, 6, and 8-12 on grounds of relevancy and admissibility depending upon the circumstances under which they are offered into evidence.

13. PLAINTIFF'S LEGAL ISSUES

To the extent they constitute legal issues, Morning Ledger intends to address the following:

a. Are the paid subscribers of each Booth newspaper assets which can be identified and valued separate and apart from goodwill?

b. Do the paid subscribers of the Booth newspapers have limited useful lives which can be estimated with reasonable accuracy?

14. DEFENDANT'S LEGAL ISSUES

a. Is the asset termed by the plaintiff "paid subscribers" an asset which is separate and apart from goodwill.

b. Is the asset termed by plaintiff "paid subscribers" an asset which can be reasonably and accurately valued.

c. Does the asset termed by the plaintiff "paid subscribers" have a useful life which can be estimated with reasonable accuracy.

15. MISCELLANEOUS

None.

16. JURY TRIALS—NOT APPLICABLE

17. NON-JURY TRIALS—Not later than January 24, 1990

a. Each side shall submit to the judge and opposing counsel a trial brief or memorandum in accordance with General Rule 27 with citation to authorities and arguments in support of its position on all disputed issues of law,* In the event a brief shall not be filed, the delinquent party's complaint or defense may be stricken.

b. Morning Ledger intends to put the following hypothetical questions to Mr. Newhouse and/or Mr. Veit and/or Dr. Urban on direct examination:

1. If a [Booth] newspaper were to choose to become a free distribution newspaper, and it wanted to maintain its level of advertising revenues, what actions would be taken to accomplish that goal?

2. If [a Booth newspaper] on May 31, 1977 were given the opportunity to purchase a set of seasoned subscribers with subscriber characteristics identical to the actual subscribers of the [Booth newspaper] on May 31, 1977, for a price in the neighborhood of $150 per seasoned subscriber, would you have made that purchase?

c. Defendant intends to put the following hypothetical questions to the following expert witnesses on

* as well proposed findings of fact and conclusions of law.

direct examination: None. Defendant, however, reserves the right to submit hypothetical questions at the time of the submission of brief in accordance with ¶ 17 of the Final Pretrial Order.

18. TRIAL COUNSEL

a. For the plaintiff:

Donald A. Robinson
Bernard J. Long, Jr.
Albert H. Turkus

b. For the defendant:

Gregory S. Hrebiniak

19. BIFURCATION

The issues of liability and damages SHALL NOT be tried separately.

20. ESTIMATED LENGTH OF TRIAL

5 days for liability and damages.

AMENDMENTS TO THIS PRETRIAL ORDER WILL NOT BE PERMITTED UNLESS THE COURT DETERMINES THAT MANIFEST INJUSTICE WOULD RESULT IF THE AMENDMENT IS DISALLOWED. THE COURT MAY FROM TIME TO TIME SCHEDULE CONFERENCES AS MAY BE REQUIRED EITHER ON ITS OWN MOTION OR AT THE REQUEST OF COUNSEL.

DOW, LOHNES & ALBERTSON
Attorneys for Plaintiff
1255 23rd Street, N.W.
Washington, D.C. 20037

By: /s/ Bernard J. Long
BERNARD J. LONG, JR.

By: /s/ Albert H. Turkus
ALBERT H. TURKUS

/s/ Donald A. Robinson
DONALD A. ROBINSON
Attorney for Plaintiff
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One Gateway Center
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/s/ Gregory S. Hrebiniak
GREGORY S. HREBINIAK
Attorney for Defendant
U.S. Department of Justice
Tax Division
555 4th Street, N.W.
Room 6810
Washington, D.C. 20001
(202) 724-6346

/s/ Ronald J. Hedges
RONALD J. HEDGES
United States Magistrate

Dated: 12/18/89

(Attachments Omitted in Printing)

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

(Title Omitted in Printing)

[Entered Feb. 1, 1990]

AMENDMENTS TO STIPULATIONS

The Stipulations of Fact set forth in ¶ 3 of the Final Pre-Trial Order are hereby amended as follows:

1. Paragraph 3 e is modified by inserting the following sentence at the beginning of the paragraph: "Herald purchased all the outstanding stock of Booth during the period beginning February 12, 1976 and ending November 5, 1976."

2. Paragraph 3 h is amended to reflect that the adjusted basis for Deferred Charges and Deposits as of May 31, 1977 was $340,331 (in accordance with the letter agreement dated October 12, 1989, rather than $340,311 as misstated in the original ¶ 3 h of the Final Pre-Trial Order).

3. Paragraph 3 i is modified by inserting the following text at the end of ¶ 3 i: "The aggregate fair market value of the going concern value and the goodwill of the Booth newspapers shall be the difference between $89,578,685 and the fair market value of the paid subscribers of the Booth newspapers, as determined by this Court. The adjusted tax basis of the paid subscribers of the Booth newspapers shall be the same proportion of $94,110,152 as the fair market value of the paid subscribers is of $89,578,685. The aggregate adjusted tax

basis of the going concern value and the goodwill of the Booth newspapers shall be the difference between $94,110,152 and the adjusted tax basis of the paid subscribers of the Booth newspapers."

4. Paragraph 3 j is amended to reflect that the number of Sunday paid subscribers to the Ann Arbor News was 37,122 (instead of 37,121 as misstated in ¶ 3 j of the original Final Pre-Trial Order).

/s/ Donald A. Robinson
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One Gateway Center
Newark, New Jersey 07102
(201) 621-7900

/s/ Albert H. Turkus
ALBERT H. TURKUS
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Attorneys for Plaintiff

/s/ Gregory S. Hrebiniak
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U.S. Department of Justice
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(202) 724-6346
Attorney for Defendant

/s/ Ronald J. Hedges
RONALD J. HEDGES
United States Magistrate

DATED: 1/24/90

PLAINTIFF'S EXHIBIT 1

[LOGO] Touche Ross

Booth Newspapers
Fair Market Value
Paid Subscribers
As of May 31, 1977

Valuation Engineering Associates

Metro Park Ill
399 Thornall Street
Edison, NJ 08837
Telephone, 201 906-9600
Telecopier, 201 906-9660

January 31, 1990

Mr. Bernard J. Long
Dow Lohnes & Albertson
1255 Twenty-third Street
Washington, DC 20037

Dear Mr. Long:

Pursuant to your authorization, we conducted a fair market value study of the paid subscribers of the Booth Newspapers, Inc. as of May 31, 1977.

For purposes of this appraisal, we define the term fair market value as "the price which property will bring when it is offered for sale by one who is willing, but is not obligated to sell it and is bought by one who is willing or desires to purchase, but is not compelled to do so." We valued the assets using value-in-use as the premise of value, which measures the assets' worth as part of a continuing business.

Based upon our appraisal procedures, we conclude the fair market values of the paid subscribers of the newspapers of Booth Newspapers, Inc., to be as follows:

Paid Subscribers—Life and Value

Groups of Subscribers	Number of Subscribers	Fair Market Value	Average Remaining Useful Life
Ann Arbor News—Daily	37,743	$ 3,966,000	14.7
Ann Arbor News—Sunday	37,122	557,000	14.7
Bay City Times—Daily	37,337	5,146,000	22.2
Bay City Times—Sunday	36,255	737,000	23.4
Flint Journal—Daily	91,366	14,392,000	18.3
Flint Journal—Sunday	91,155	1,810,000	18.5
Grand Rapids Press—Daily	120,011	13,250,000	17.7
Grand Rapids Press—Sunday	106,859	1,761,000	21.2
Jackson Citizen Patriot —Daily	35,711	4,622,000	17.9
Jackson Citizen Patriot —Sunday	35,632	688,000	18.9
Kalamazoo Gazette—Daily	51,481	6,655,000	17.0
Kalamazoo Gazette—Sunday	52,960	1,021,000	17.6
Muskegon Chronicle—Daily	41,203	5,116,000	18.0
Muskegon Chronicle—Sunday	40,609	651,000	16.2
Saginaw News—Daily	49,327	6,446,000	17.4
Saginaw News—Sunday	48,942	955,000	18.3
Total		$67,773,000	

• • • •

Paid Subscribers Valuation

We identified sixteen groups of paid subscribers as intangible assets that support the operations of Booth Newspapers.

The subscriber groups include the daily and Sunday subscribers for the following newspapers: *The Ann Arbor News*, *The Bay City Times*, *The Flint Journal*, *The Grand Rapids Press*, *The Jackson Citizen Patriot*, *The Kalamazoo Gazette*, *The Muskegon Chronicle*, and *The Saginaw News*.

To determine the value of the paid subscribers, we projected the future retirement activity based on the current paid subscribers. To estimate the future retirement activity of the paid subscribers, we relied upon subscriber survivor information contained in a report issued by Statistical Research, Inc. (SRI) as modified by the stipulation of the parties. The SRI report provided a mortality table delineating the percent of the original population that was still active at each annual interval for the paid subscribers. These mortality tables define a survivor curve for the subscribers of each of the sixteen subscriber groups.

We used the retirement activity represented by the SRI survivor curves, as modified by the stipulation, as a forecast for future retirement activity. Combining the age distribution of the existing subscribers, as taken from the SRI report, the anticipated future retirement activity, and the current level of net revenues, we forecast the future cash flows that would be derived from these subscriber bases. We discounted these cash flows to generate the net present value for each group of subscribers.

Discounted Cash Flow Approach

To determine the value of the paid subscribers of the Booth newspapers, we used the discounted cash flow approach. First we performed a pro forma analysis of the paid subscribers to estimate cash flow. Cash flow per subscriber is derived by using the following analysis:

Revenue per subscriber per day (subscription price less cost of delivery)

Less: (Cost to collect per day)

Equals: (Daily pretax cash flow attributable to each subscriber)

This definition is based upon the fact that a paid subscriber paper and a free distribution newspaper have the same categories of revenues and expenses, with the excep-

tion of the subscriber revenue and the cost to collect that revenue. Therefore the subscriber revenue less the cost to collect is the net cash flow attributable to the existence of each paid subscriber.

The results of the above described analysis were presented in a report prepared by American Valuation Consultants, Inc. and incorporated into a later report by Price Waterhouse. We accepted those values as being accurate and summarized them in Table I-1.

Table I-1

Daily Net Subscription Revenue Per Subscriber

Group of Subscribers	Cash Flow/Day/Paid Subscriber
Ann Arbor News—Daily	$0.0953
Ann Arbor News—Sunday	0.0952
Bay City Times—Daily	0.1079
Bay City Times—Sunday	0.1075
Flint Journal—Daily	0.1193
Flint Journal—Sunday	0.1143
Grand Rapids Press—Daily	0.0924
Grand Rapids Press—Sunday	0.0913
Jackson Citizen Patriot—Daily	0.1054
Jackson Citizen Patriot—Sunday	0.1054
Kalamazoo Gazette—Daily	0.1073
Kalamazoo Gazette—Sunday	0.1076
Muskegon Chronicle—Daily	0.1006
Muskegon Chronicle—Sunday	0.1005
Saginaw News—Daily	0.1083
Saginaw News—Sunday	0.1082

To project the future annual cash flow associated with each subscriber, we multiplied the daily cash flow from net subscription revenue per subscriber by the number of days per year for each edition of each paper. We assumed that all daily papers were published six days per week, 52 weeks per year and that the Sunday editions comprised 52 editions annually. Moreover, we projected that the subscription rates would experience an inflationary

growth rate of 4 percent annually, based upon information published in the 1976 edition of *Predicasts*. Then we applied the retirement rates from the previously described survivor curves to the cash flow forecast. The product of the base year cash flow, times the growth rate, times the retirement rate yielded the expected future annual cash flows from existing subscribers. We then discounted the annual cash flows to produce a present value which represents the price a prudent investor would pay for the existing paid subscribers of the Booth newspapers as of May 31, 1977.

Tax Rate

The current federal statutory income tax rate, at the date of valuation, is 46 percent of pretax income. The Michigan activity tax is 2.35 of pretax income. Thus, we projected that the tax rate of Booth Newspapers, Inc., would be 47.3 percent of pretax income.

Discount Rate

As we detail in Exhibit I, we calculated the appropriate discount rate to be 15 percent.

Conclusion of Value

Based upon our analysis, we conclude that the fair market value of the paid subscribers is $67,773,000. We present the results of our pro forma discounted cash flow analysis for each group of paid subscribers in Exhibit II. We summarize the results of our cash flow analysis and determination of average remaining useful life for each group of paid subscribers in Table I-2.

Table I-2

Paid Subscribers—Life and Value

Groups of Subscribers	Number of Subscribers	Fair Market Value	Average Remaining Useful Life
Ann Arbor News—Daily	37,743	$ 3,966,000	14.7
Ann Arbor News—Sunday	37,122	557,000	14.7
Bay City Times—Daily	37,337	5,146,000	22.2
Bay City Times—Sunday	36,255	737,000	23.4
Flint Journal—Daily	91,366	14,392,000	18.3
Flint Journal—Sunday	91,155	1,810,000	18.5
Grand Rapids Press—Daily	120,011	13,250,000	17.7
Grand Rapids Press—Sunday	106,859	1,761,000	21.2
Jackson Citizen Patriot —Daily	35,711	4,622,000	17.9
Jackson Citizen Patriot —Sunday	35,632	688,000	18.9
Kalamazoo Gazette—Daily	51,481	6,655,000	17.0
Kalamazoo Gazette—Sunday	52,960	1,021,000	17.6
Muskegon Chronicle—Daily	41,203	5,116,000	18.0
Muskegon Chronicle—Sunday	40,609	651,000	16.2
Saginaw News—Daily	49,327	6,446,000	17.4
Saginaw News—Sunday	48,942	955,000	18.3
Total		$67,773,000	

Based upon our analysis and that of Statistical Research, Inc., we were able to determine both lives and values for Booth Newspapers' paid subscribers which are distinctly different from goodwill. Treasury regulations provide for amortization of intangible capital assets:

> "If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an asset may be the subject of a depreciation allowance."

In our opinion there is no doubt that paid subscribers do produce income and for a limited period of time. We have, in other circumstances, determined that limited

period of time for subscribers to other newspapers and publications. In this case the parties have entered into a stipulation regarding that limited period. Therefore, based upon the SRI report, the stipulation, and our analysis, it is our opinion that the value of the paid subscribers and their useful life have been determined with reasonable accuracy and as such the paid subscribers are separate from goodwill.

• • • •

PLAINTIFF'S EXHIBIT 2

REPORT ON THE AVERAGE REMAINING LIFE OF SUBSCRIPTIONS TO BOOTH NEWSPAPERS

STATISTICAL
RESEARCH, INC.
111 Prospect Street
Westfield, New Jersey 07090
201-654-4000

March 1978

REPORT ON THE AVERAGE REMAINING LIFE OF SUBSCRIPTIONS TO BOOTH NEWSPAPERS

Prepared by
Statistical Research, Inc.

Summary

This is a report on the average remaining life of subscriptions to the following Booth newspapers:

Ann Arbor News
Bay City Times
Flint Journal
Grand Rapids Press
Jackson Citizen Patriot
Kalamazoo Gazette
Muskegon Chronicle
Saginaw News

The results are based on statistical analyses of data collected in surveys of subscribers to the newspapers.

These surveys were conducted by Statistical Research, Inc. (SRI) during the period November 1977-February 1978. They involved selecting a probability sample of subscribers, drawn from subscriber lists submitted by the newspapers. Selected subscribers were then contacted by telephone, personal delivery, or mail, and interviewed primarily to determine the length of time they had subcribed.

For purposes of the study, a subscription has been defined as continuous delivery to a particular address either by carrier or, in a few cases, by mail. The specific question asked of subscribers was, "For how long has the (e.g.) Ann Arbor News been delivered to your present address?"

Data collected in the surveys were used to construct, by appropriate statistical methods, mortality tables for subscriptions to each newspaper. Separate tables were prepared for daily and Sunday subscriptions, though there is considerable overlap because most subscribers have the paper delivered both daily and Sunday. Mortality experience tables for each newspaper are included in the following section.

Each mortality table is based solely on the experience of the paper it refers to. Thus, each table has been constructed independently of the others, based on relevant data, and each has its own unique actuarial characteristics.

In some tables, experience indicates that the expected (remaining) life of a subscription decreases slightly over time, thereby demonstrating some aging factor. In other tables, experience indicates that the remaining life increases slightly over time, thereby demonstrating some wear-in or "infant" mortality factor.

However, all of the tables indicate that the remaining life of a subscription does not vary much with the age of the subscription. This fact is not surprising and is consistent with a large body of applicable statistical theory.

Mortality tables of subscriptions, in turn, permit calculation of the average remaining life of subscriptions to each newspaper. These results are as follows:

Newspaper	Daily	Sunday
Ann Arbor News	9.8	9.8
Bay City Times	14.8	15.6
Flint Journal	12.2	12.3
Grand Rapids Press	11.8	14.1
Jackson Citizen Patriot	11.9	12.6
Kalamazoo Gazette	11.3	11.7
Muskegon Chronicle	12.0	10.8
Saginaw News	11.6	12.2

The study also provides the basis for determining the number of daily and Sunday subscriptions to each newspaper. These results are as follows:

Newspaper	Daily	Sunday
Ann Arbor News	37,743	37,122
Bay City Times	37,337	36,255
Flint Journal	91,366	91,155
Grand Rapids Press	120,011	106,859
Jackson Citizen Patriot	35,711	35,632
Kalamazoo Gazette	51,481	52,960
Muskegon Chronicle	41,203	40,609
Saginaw News	49,327	48,942

Subsequent sections of this report describe (a) statistical methods used in developing mortality experience tables, (b) determination of number of daily and Sunday subscriptions to each newspaper, and (c) procedures employed in conducting the surveys of subscribers.

PLAINTIFF'S EXHIBIT 3

FAIR MARKET VALUE STUDY OF
PAID NEWSPAPER SUBSCRIBERS
TO
BOOTH NEWSPAPERS
AS OF
MAY 31, 1977

Price Waterhouse [LOGO]

Price Waterhouse

January 31, 1990

Newark Morning Ledger Company
c/o Paul Scherer
Paul Scherer & Company,
Certified Public Accountants
330 Madison Avenue
New York, New York 10017

Dear Mr. Scherer:

This report sets forth our analysis of the Fair Market Values of the paid newspaper subscribers to the eight newspapers published by Booth Newspapers, Inc., ("Booth") as of May 31, 1977.

Fair Market Value is defined as the price at which property would change hands between a willing buyer and a wililng seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both having reasonable knowledge of relevant facts. For purposes of this engagement, the Fair Market Values of the subject assets were analyzed assuming the newspaper operations of Booth were continued as an ongoing business.

In performing our work, we took such steps as we considered appropriate to arrive at our conclusions of values including the following:

- Visits to the operations of each of the Booth newspapers:

  The Ann Arbor News, Ann Arbor, Michigan
  The Bay City Times, Bay City, Michigan
  The Flint Journal, Flint, Michigan
  The Grand Rapids Press, Grand Rapids, Michigan
  Jackson City Patriot, Jackson, Michigan
  Kalamazoo Gazette, Kalamozoo, Michigan

The Muskegon Chronicle, Muskegon, Michigan
The Saginaw News, Saginaw, Michigan

and to the corporate headquarters and computer center in Ann Arbor, Michigan;

- Discussions with newspaper management, both operating and financial, concerning the markets within which each newspaper operates, the operations of each newspaper, and the historic financial results and strategic outlook for each newspaper;
- Research into the newspaper industry at an economy-wide level to study the development of the industry as a whole and research into the economic and competitive environment in which each of the newspapers operates;
- Analysis of the paid subscribers (not including single copy sales) to Booth newspapers as of May 31, 1977.

In performing our valuation, we used and relied on the accuracy and completeness of various historical and prospective information provided to us or contained in public sources. We have also incorporated certain data and analysis developed by and under the direction of Roger J. Grabowski, National Director of Valuation Services of Price Waterhouse and author of this report, during the period of his employment by American Valuation Consultants, Inc., as contained in the report "Fair Market Value Study of Booth Newspapers, Inc., for The Herald Company as of May 31, 1977," prepared by American Valuation Consultants, Inc. dated May 4, 1979.

We also read "Report on the Average Remaining Life of Subscriptions to Booth Newspapers" prepared by Statistical Research, Inc., dated March 1978; we used the results contained therein in our valuation as revised by stipulation of the parties. However, we have not been engaged to compile, review, or examine such information or these reports in accordance with standards established

by the American Institute of Certified Public Accountants and, accordingly, do not express our opinion or any form of assurance thereon.

* * * *

II. *PAID NEWSPAPER SUBSCRIBERS*

We determined the appropriate method of valuing the paid subscribers (excluding single copy sales) is to capitalize the cash flows expected to be received from the paid subscriber (income approach to value). We also considered the cost approach but concluded that it is too difficult to estimate accurately the full replacement cost of a "seasoned" group of paid subscribers (i.e., a group of paid subscribers with the same remaining life characteristics as the paid subscribers to the Booth newspapers at the valuation date).

A cost approach is inappropriate because the expenditures observed at each Booth newspaper for outside sales organizations to solicit subscribers are simply the cost to attract a new, marginal subscriber. It is a well-recognized fact that new subscribers as a group have a shorter expected "life" (subscription period) than a group of seasoned paid subscribers. In fact; a number of new subscribers must be signed to obtain even one who will have a useful life comparable to that of a seasoned subscriber.

In addition, a valuation based upon the cost approach is only hypothetical because these seasoned subscribers are not available for sale other than in connection with the newspaper to which they subscribe. While a cost approach estimate may be a useful method of corroborating a valuation based on estimated cash flows, a prudent investor will measure the benefits of ownership based on the capitalized cash flow expected from ownership of the asset.

In capitalizing the cash flows, the prudent investor determines Fair Market Value according to the value of the cash flows that an asset can be expected to generate over its useful life. In using this approach, we first project the annual cash flows that an asset will generate over its useful life and then convert these cash flows into a present value equivalent through a process known as discounting.

The discounting process uses a rate of return which accounts for (1) the relative risk of not realizing the estimated cash flows and (2) the time value of money. We then project the residual value of the asset at the end of its useful life and convert it to its present value equivalent. Often that residual value is zero. The Fair Market Value of an asset is equal to the sum of the present value of the projected cash flows and the present value of the residual value.

The following discussion explains the steps that we used in calculating the cash flows attributable to the paid subscribers:

1. *Remaining Useful Life*

   We were provided with a report performed by Statistical Research, Inc., which provided a survivor table delineating the percent of the original paid subscribers that could be expected to remain subscribers at each future year-end. We used the results of that study in our valuation as revised by stipulation of the parties.

2. *Marginal Revenue Per Newspaper From Each Paid Subscriber*

   The prudent investor must calculate the additional revenue that each newspaper will receive from each paid subscriber. The first step was to calculate the number of publications each subscriber received during the year. Each daily newspaper was received at

least 312 days per year by the subscribers; each Sunday newspaper was received at least 52 days per year by the subscribers.

The next step was to determine the revenue the newspaper receives from each paid subscriber. The revenue per subscription was calculated using the actual revenue which each newspaper receives (based on the posted subscription price for a combined daily and Sunday subscription which is the lowest posted priced subscription) minus the collection costs and the salaries and benefits of the personnel who work in the collections area. No costs other than collection costs were subtracted from daily revenue received by each newspaper because no other marginal expenses were associated with the subscription revenue.

The prime target market of any newspaper is the retail advertising account, as advertisers' revenues normally generate 60% to 75% of a newspaper's total revenue and averaged 77% of the Booth newspaper operations revenue for the years 1973 through 1976. Advertising rates are dependent upon circulation. However, advertising revenue will exist even wtihout paid subscribers. Some newspapers are given away to establish the circulation necessary to get a guaranteed advertising rate.

In calculating the marginal revenues expected from the paid subscribers, we were conservative in that we did not project any future increases in the marginal revenue per subscriber.

The calculations of revenue per subscriber and collection costs were performed by American Valuation Consultants, Inc., and the results are contained in its report. Pertinent excerpts from the American Valuation Consultants, Inc., reports are contained in Appendix I. We used the results of its work as reported therein in our valuation. These calculations are summarized the the following table:

TABLE 1

As of May 31, 1977

	Number of Subscribers Daily	Sunday	(1) Average Revenue Per Subscriber Per Day	Total Cost To Collect Per Day
Ann Arbor News	37,744	37,121	.104679	$401.41
Bay City Times	37,338	36,255	.120918	487.52
Flint Journal	91,366	91,155	.122275	727.11
Grand Rapids Press	120,011	106,859	.100698	999.05
Jackson Citizen Patriot	35,710	35,634	.115005	343.98
Kalamazoo Gazette	51,481	52,958	.116400	466.85
Muskegon Chronicle	41,204	40,609	.108207	311.97
Saginaw News	49,328	48,941	.118900	523.06

3. *Total After-Tax Marginal Revenue From the Paid Subscribers*

To determine the total marginal revenue from the paid subscribers in any year, we multiplied the average number of subscribers subscribing during each year (average of the subscribers at the beginning and end of each year) times the number of days the subscribers receive the newspapers and then multiplied by the average revenue per subscriber per day. We then subtracted the total cost to collect the revenue and adjusted for income taxes using a rate of 50% for the combined federal and effective state income taxes.

4. *Fair Market Value of Cash Flows*

We computed the present values of the resulting after-tax cash flows. The calculations are shown in Exhibit I. We used a 13% after-tax rate of return in our calculations. Exhibit II contains the explanation and calculation of the rate of return.

The Fair Market Value (FMV) (that is, the price at which the asset can be expected to change hands between the willing buyer and a willing seller) can be calculated by adding the present value of the asset's

after-tax cash flows before amortization plus the present value of the tax savings which will be realized due to amortization of the asset. The following relation is used to calculate the value of the asset:

FMV = Present Value of After-Tax Cash Flow before Amortization of the Paid Subscribers

Plus

Present Value of Income Tax Savings due to Amortization of the Paid Subscribers

= Present Value of After-Tax Cash Flow before Amortization of the Paid Subscribers

Plus

FMV

Times: AF

Times: Income Tax Rate (50%)

Where:

FMV = Total Fair Market Value of the Paid Subscribers

AF = Amortization Factor

= Sum of ((1/Useful life as stipulated) * (Present Value Factor year i))

= Present Value of amortization per dollar of FMV

To calculate the Fair Market Value using the above formula, one solves algebraically the formula for the "unknown" "FMV." We used the straight-line method to calculate the amortization of the paid subscribers.

In applying the straight-line method, each year's amortization percentage is calculated by dividing one (i.e., "1") by the Useful Life as stipulated. We calculated the Amortization Factor used in the above formula as the sum of the present value of the amortization percentages (that is, amortization percentage for each year times the appropriate present value factor for that year summed for all years of the Useful Life as stipulated).

Based on our investigation and analysis, we conclude that the total Fair Market Value of the existing paid newspaper subscribers as of May 31, 1977, was:

SIXTY MILLION FOUR HUNDRED
SEVENTY THOUSAND DOLLARS

($60,470,000)

Revised Table 2 summarizes the results for each newspaper.

TABLE 2

Newspaper		No. of Subscribers	Useful Lives[1]	FMV Per Subscriber	Total FMV[2]
Ann Arbor News	—daily	37,744	14.7	$ 86.54	$ 3,266,366
	—Sunday	37,121	14.7	14.29	530,533
Bay City Times	—daily	37,338	22.2	124.10	4,633,483
	—Sunday	36,255	23.4	21.11	765,263
Flint Journal	—daily	91,366	18.3	131.83	12,044,440
	—Sunday	91,155	18.5	21.96	2,001,541
Grand Rapids Press	—daily	120,011	17.7	99.58	11,951,244
	—Sunday	106,859	21.2	16.93	1,809,092
Jackson City Patriot	—daily	35,710	17.9	109.52	3,910,854
	—Sunday	35,634	18.9	18.29	651,854
Kalamazoo Gazette	—daily	51,481	17.0	113.17	5,826,130
	—Sunday	52,958	17.6	19.16	1,014,808
Muskegon Chronicle	—daily	41,204	18.0	112.08	4,618,250
	—Sunday	40,609	16.2	18.09	734,611
Saginaw News	—daily	49,328	17.4	116.53	5,748,166
	—Sunday	48,941	18.3	19.70	964,162
					$60,470,896
				Say to:	$60,470,000

(1) Based on stipulation of parties

(2) Number of Subscribers X FMV per subscriber

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PLAINTIFF'S EXHIBIT 4

AN OVERVIEW OF PAID DAILY NEWSPAPER CIRCULATION TRENDS

Urban & Associates, Inc.
Sharon, Massachusetts

The Importance of Subscribers

A paid circulation newspaper operates in two separate economic markets: competing with a wide range of other print and electronic media for revenues from both readers and advertisers.

A newspaper's subscribers—i.e.: the customers who pay to have the paper delivered to their homes or businesses by hand delivery or by mail—are a direct source of substantial revenue to the newspaper, usually representing between 20-30% of the total revenues of the business. Moreover, the number of paying subscribers to a newspaper at a particular point in time is significant to advertisers because it reflects the community's acceptance and readership of the paper at that time, due to the paper's ability to meet market needs through provision of a quality editorial product and good circulation service. (The reports published by the Audit Bureau of Circulations are a widely-accepted measure of a newspaper's circulation.)

Given the importance of paid subscribers, daily newspapers are continuously involved in efforts to sell subscriptions and build circulation. These circulation numbers are only meaningful, of course, in relation to the number of households in the market, with market penetration (i.e.: the proportion of households reached by the newspaper) being the most important indicator of how well the newspaper is doing. Even if a newspaper's circulation remains stable or grows slightly, then, its ability to generate revenues is threatened if the rate of household formation in its market exceeds that growth.

The stagnant circulation and declining market penetration trends facing most paid daily newspapers across the country threaten both subscription and advertising revenues, because there are many viable competitors willing and able to fulfill both reader and advertiser demand. Thus, newspapers expend considerable efforts to maintain and develop their circulation, in recognition of the fact

that failing to do so would eventually result in failure of their business.

Trends in Newspaper Circulation and Readership

Even a cursory examination of long-term trend data from the newspaper industry (see exhibits on the following pages) suggests that over the past twenty years, there has been a continuous decline in both the proportion of households that **subscribe** to a newspaper as well as the number of U.S. adults that **read** a newspaper at all. These downward trends have occurred **despite** newspapers' intensive efforts to increase circulation.

The revenue significance of a diminishment in audience size and market penetration is clear: not only are newspapers across the country worried about these trends, they have considered them a potent mandate requiring significant and on-going investments in building circulation that not only **should** but **must** be made to preserve their ability to do business.

* * * *

Industry Reactions to Declining Circulation

With its paid subscribers at risk, the newspaper industry has paid considerable and deserved attention to the issue of declining readership and newspaper subscriptions. Over the past five to ten years, for instance, it would be hard to find any trade publication, any industry meeting or conference program, or any individual newspaper's strategic plan that did not address either **an explanation** of the readership problem or the **investments required** to solve it.

In general, most U.S. paid daily newspapers have made (and continue to make) substantial investments in:

1) **circulation sales programs** to attract new readers and subscribers to the newspaper (with commonly-

used techniques including telephone solicitation campaigns, door-to-door sales, reduced price offers, distribution of free samples of the newspaper, carrier sales incentives and contests, direct mail solicitations, etc.)

2) **subscriber retention programs** to hold existing subscribers who are about to cancel their subscriptions (encompassing efforts to improve present subscribers' satisfaction with the quality of home-delivery service provided as well)

3) **market research studies** to identify what non-readers and infrequent readers want in their newspapers, and track the success of sales and retention programs, and

4) **product improvements** to attract and hold readers, including not only the addition of new content (e.g.: new sections, more space in the paper to enhance news coverage, purchase of new syndicated features, etc.) but also improvements in packaging (e.g.: significant redesigns, additions of color and graphics to the paper, etc.) to help the newspaper be a more valuable and easier to use source of news and information to its readers.

Since the early part of the 1970's, most newspapers across the U.S. have made concerted efforts in some or all of these areas, especially in circulation sales programs. Many, for instance, invested heavily in solicitation campaigns that offered premiums and half-price offers to attract new circulation, only to see many new subscribers cancel their subscription when the premium was received or the half-price offer expired. As expensive as it has been to **obtain new subscribers**, then, experience has proven that equally aggressive levels of financial investment in high quality editorial content and good circulation service are required to **retain subscribers** as well. The true cost of acquiring circulation, then, is not the cost of the sales

programs alone but the entire investment required to provide subscribers with the levels of product and service quality that they demand.

Summary

No one familiar with paid daily newspapers, then, would dispute three essential facts about the business:

1) circulation and **market penetration** are the essential foundation on which all newspaper revenues are derived

2) **obtaining** and **retaining** subscribers to a newspaper is not an automatic process, but is instead a difficult and expensive requirement of doing business, and

3) declining circulation and penetration of paid daily newspapers has been a **long-standing trend**, and will very likely continue to be an industry-wide concern for years to come.

There is little evidence to suggest that the solutions to the problem will be inexpensive or immediate, and no reason to believe that **any** paid daily newspaper in **any** market is immune from ever-increasing competitive pressures and reader expectations. Despite this, a paid daily newspaper must continue to **obtain** and **retain** subscribers, since cessation of efforts to do so would inevitably result in the attrition of an essential revenue-producing asset and failure of its business.

Continuous investment in product enhancement, circulation sales and subscription retention strategies have **always** been a normal operating cost of **doing business** for paid daily newspapers. Even more so today, these investments are a required cost of **staying in business** in an increasingly difficult and competitive environment.

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DEFENDANT'S EXHIBIT 1

HERALD COMPANY
CONTROL NO. 5I1612

THE FAIR MARKET VALUE OF THE BOOTH NEWSPAPERS INC.'S SUBSCRIPTION LISTS AS OF MAY 31, 1977

PREPARED BY
JOSEPH P. BANIEWICZ
FINANCIAL ANALYST
INTERNAL REVENUE SERVICE
1111 CONSTITUTION AVENUE, N.W.
WASHINGTON, D.C. 20224
MAY 9, 1986

• • • •

IV. *Valuation Analysis*

A. Definition of the List

Before the value of newspaper's subscription list can be determined, it needs to be identified and defined. In the case of the Booth lists that were acquired by the Herald in 1976 and are the subject of the value allocation in the May 31, 1977 liquidation, they are the names and addresses of the specific subscribers to the various Booth daily papers. The names are evidence of the demand for the daily papers by individuals in the communities. They represent the communities' households, who want regular and continuous delivery of the dailies. It is the list of subscribers who can terminate the subscription at will if they no longer desire the product—the daily paper. In the case of the Booth papers in 1977, the company did not directly possess a list of subscribers on file in the newspapers' offices. Rather the lists were kept by the newspapers' carriers, who were not employees of the papers but rather were independent contractors of the papers. When a carrier terminated his or her relationship with a paper, the list of subscribers on the route was transferred to the new carrier. It is assumed for the purpose of this report that the lists were owned by Booth even though there was not direct possession in 1977.

In terms of the sale and circulation of the product, the daily paper, the lists possessed by the carriers is a valuable business asset that helps maintain a regular and stable circulation of a daily paper.

Circulation, in reality, is the very foundation upon which a newspaper publishing business is built. It is always a matter of first importance in the purchase and sale of a newspaper publication.

Circulation, as used in the newspaper industry, comprehends something much broader than what may be characterized as mere subscription lists. It comprehends, on

the one hand, a body of subscribers whom experience has demonstrated may be relied upon with some degree of certainty to continue to take and renew their subscription to the paper in the future. On the other hand, it includes within its scope an established advertising clientele who uses the paper as a medium by which to reach the purchasing public.

Circulation, the number of newspapers sold, is the lifeblood of a newspaper; it is the basis of all revenue. It is true that newspaper sales account for less revenue than advertising, but circulation is the force that makes advertising pay. Without circulation a newspaper would carry no advertising, and without advertising a newspaper could not survive. Circulation is the measure to which a paper meets the needs of the consumers in its community. The greater the circulation, the stronger the evidence that a newspaper is fulfilling the needs of its community.

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The subscription list of a newspaper is a valuable intangible asset. However, it should not be equated with the broader concept of circulation, which defines the franchise of a newspaper. The franchise is the value of an established newspaper's presence in a given market in the industry, that has naturally evolved in an economic sense to have monopolistic characteristics. The broader concept of circulation is inextricably related to the editorial and advertising product, the paper itself. This broader concept of circulation is related to and often termed goodwill. Goodwill is defined as that element of value which adheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business. Goodwill in the newspaper industry for single daily markets such as the Booth papers is based on the circulation or preference of its customers to buy editions of its papers. The concept of goodwill in the newspaper business is called the franchise value due to the economic reality that without the circulation structure of an established paper, an out-

side publisher normally will not be able to come into a specific area and compete.

In contrast to the broader concept of circulation, the subscription list is the names, addresses and payment history of the subscribers, which enables the newspaper publisher to deliver the product on a regular and continuous basis to a large percentage of the purchasers of the editions of the newspaper. The broader concept of circulation and its significant value is related to and not separate and apart from the goodwill (franchise) of a daily newspaper.

B. Cost of Obtaining Subscribers

1. Company Interviews and Questionnaires

Newspapers are constantly attempting to acquire new subscribers. Newspapers in medium-sized cities such as Booth's undertake several promotions per year. In 1977, the Booth newspapers conducted circulation drives, which were mainly carrier contests. I obtained information from the circulation managers of each of the Booth newspapers on subscription drives. The circulation managers provided the cost range and indicated the varying costs depended upon the relative success of a given campaign. From the cost ranges provided, the midpoint unit cost for each of the newspapers and the average midpoint unit cost per subscriber were calculated as follows:

Cost of Subscribers as a Result of Circulation Drives

Newspaper	Unit Cost Range	Midpoint of Range
Ann Arbor Times	$8.00 to $18.00	$13.00
Bay City Times	$1.00 to $ 4.00	$ 2.50
Flint Journal	$5.00 to $20.00	$12.50
Grand Rapids Press	$3.00 to $10.00	$ 6.50
Jackson Citizen Patriot	$3.00 to $ 9.00	$ 6.00
Kalamazoo Gazette	$3.00 to $10.00	$ 6.50
Muskegon Chronicle	$3.00 to $ 5.00	$ 4.00
Saginaw News	$3.50 to $ 7.50	$ 5.50
	Average Midpoint Unit Cost	$ 7.06

2. Outside Sales Force Circulation Drives

Third party solicitation firms are occasionally employed to attract new subscribers to newspapers. Although when interviewed the circulation managers of the Muskegon Chronicle indicated that the paper did not employ this method, the American Valuation Consultants' report indicates that in September, 1976, the Jones Boys, a Michigan solicitation firm, was hired by the Muskegon Chronicle to obtain new subscribers. Over 3,600 new orders were sold at $4.50 each, with a 13 week money back guarantee. The $4.50 rate was for a combined daily and Sunday subscription. The rate for a daily subscription was $3.00 and for a Sunday subscription only was $1.50. The report also indicates that the Milne organization, another solicitation firm, quoted $5.60 to $7.00 (depending upon the area) per subscriber as the charge to successfully solicit subscribers.

Since the Muskegon Chronicle actually used the Jones Boys, who charged $4.50, it is my opinion that it represents the cost paid to an outside solicitation firm for the Chronicle and also the other Booth papers. However, the $4.50 per combined circulation unit is only the amount paid to the outside firm. The newspaper itself will incur internal cost in order to initiate the drive with the outside solicitor, promote the drive, process orders, and communicate the orders to the carriers. It is assumed that these internal costs will raise the total cost per unit to the $7.00 per unit level as determined in the previous section.

In conclusion, the cost of outside circulation drives and in-house circulation campaigns are approximately the same. This is a reasonable result because if there was a large differential in cost, the higher would not be used due lack of economic effectiveness.

The costs involved in either the outside solicitors or the in-house circulation drives of approximately $7.00 per subscriber, if applied without any adjustment to the total

number of subscribers of a daily newspaper, result in an overvaluation of the paper's subscription list. The overvaluation results because the circulation drives represents the cost of acquiring marginal subscribers. Most of the subscribers of a daily newspaper consider the product as a necessity and will subscribe with little or no solicitation effort. They desire the established daily paper in their geographic locale because of the news, information, and advertising that the paper carries. In contrast, the subscribers that are targeted in a circulation drive, are persons that are currently not subscribing for a variety of reasons, such as low income level (cost), illiteracy (usefulness) or newsstand sales (convenience). The marginal subscribers are more difficult to successfully solicit than the average subscriber that is acquired in a purchase of a newspaper property. Therefore, the marginal subscriber's cost, if used to value the acquired Booth subscription, would result in an overvaluation.

Although the marginal subscriber acquired in a circulation drive is normally more costly to obtain than those that are acquired in the purchase of a newspaper property, the value of the marginal subscriber in terms of circulation is less than those subscribers that are acquired in a total newspaper purchase because the marginal subscribers do not have the same retention rate as the average subscriber on the list purchased when a newspaper property is acquired. However, the value of circulation list of an acquired property is something that is attributable to more than merely the subscription list, the intangible asset that is separate and apart from the goodwill (franchise value) of the operation. The value of the subscribers on the list is derived from the fact that these subscriber want and need the daily paper. The daily paper is a product of the publisher, who has a monopolistic position in the specific market served.

It was indicated that using the cost of obtaining marginal subscribers results in overvaluing the subscription

list, acquired in a purchase of a newspaper property. The ideal, but nonexistent, situation from which to calculate the value of an newspaper's subscription list is one in which the established newspaper suddenly and completely loses its subscription list. The newspaper, with its same strong market position and same product, must then mount a subscription campaign to move from zero subscribers to the number it had before losing its list. Many customers would be easy to attract, easier than the marginal subscribers sought under normal circulation drives. Therefore, the average cost per subscriber would be less than the average cost per marginal subscriber of $7.00 previously indicated.

In 1977, telephone solicitation firms conducted their operations in a number of ways. One was to identify all the telephone exchanges in a given paper's area of circulation and to call all the numbers in each of those exchanges. This resulted in contacting all the telephone households in the circulation area, including unlisted numbers. The households telephoned were asked if they were currently subscribers. If they answered negatively, they were given the sales pitch. The firm's fee to the client reflected the cost of contacting both current and prospective subscribers. Since 1977, it was indicated at the interview of the Booth circulation managers that with the availability of electronic autodialers, Booth conducts similar operations inhouse to attract marginal subscribers. This process by Booth also provides a means to check carrier service to current subscribers.

It can be concluded that the value of the subscription list on a cost basis should be less than $7.00 per marginal subscriber. Based on this fact it is my opinion that a value of $5.00 per subscriber adequately reflects the cost that would be incurred in replacing the entire subscription list of an individual paper. The $5.00 figure is based on the efficiency of developing the entire list, where the success of soliciting would be higher than that of the

marginal subscriber campaign. Basing the value of subscription lists of Booth on costs of this magnitude is consistent with other taxpayers' appraisals that I have had the opportunity to review.

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It could be argued that the later revaluation is the result of additional new subscribers that replace some of the original subscribers acquired in 1977. These new subscribers, who may be (1) new households formed in the market, (2) households migrating to the market, or (3) existing households of the market deciding to subscribe to home delivery, would be capitalized at the cost equivalent to the circulation expenses that may be elected to be capitalized under I.R.C. Section 173. They would not be capitalized at values of the magnitude proposed by the Herald Company; they would be capitalized at values of the magnitude indicated by the cost of new subscribers or the market value of lists acquired separate and apart from a going business, although they may be expensed under the legislative grant of Section 173.

Conclusion

It is my opinion that the fair market value of the Booth newspapers' subscription lists should be based on the value of $5.00 per subscriber (for daily and Sunday combined) that was determined in sections of this report on the Cost of Obtaining Subscribers and Market Valuation of Lists. Since there is not an equal number of daily and Sunday subscriptions for each of the newspapers, the Sunday subscriptions are valued at one third of the $5.00 value, or $1.67 per unit, and the lists' value is adjusted upward or downward on the $1.67 value depending upon whether there are more or less Sunday subscriptions than daily subscriptions. The value of a Sunday subscription at $1.67 reflects the relative value of a Sunday subscription versus a combined daily and Sunday subscription on the basis of cost paid to a solicitation firm.

Based on the information on the number of daily and Sunday subscriptions supplied by the Herald Company and the values of $5.00 for a combined daily and Sunday and $1.67 for Sunday only, the following values are calculated for the individual newspapers' subscription lists:

Newspaper	Subscriptions Daily	Subscriptions Sunday	Fair Market Value
Ann Arbor News	37,743	37,122	$187,678
Bay City Times	37,337	36,255	185,203
Flint Journal	91,366	91,155	456,478
Grand Rapids Press	120,011	106,859	578,091
Jackson Citizen Patriot	35,711	35,632	178,423
Kalamazoo Gazette	51,481	52,960	259,875
Muskegon Chronicle	41,203	40,609	205,023
Saginaw News	49,327	48,942	245,992
Fair Market Value of Subscription List			$2,296,763

In summary the fair market value of the Booth newspapers, Inc.'s acquired subscription lists was $2,296,763 and such value does not reflect any adjustments due to I.R.C. Section 334(b)(2).

This value reflects the value of the subscription lists as an intangible asset, separate and apart from the going concern and goodwill (franchise) values of the newspapers. This value is distinguishable from the circulation value determined in the teaching of the *Donrey* case in that it does not encompass the value of circulation in its broader sense, which is not separate and apart from the going concern and goodwill (franchise) of newspapers.

Submitted by,

/s/ Joseph P. Baniewicz
JOSEPH P. BANIEWICZ
Financial Analyst

Attachments No. 1 through 6

DEFENDANT'S EXHIBIT 5

FAIR MARKET VALUE STUDY OF BOOTH NEWSPAPERS, INC. FOR THE HERALD COMPANY AS OF MAY 31, 1977

American
Valuation Consultants
a subsidiary of
Valuation
Research Corporation

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Newspaper Subscribers

The newspaper subscribers are intangible assets which generate direct subscription revenue. Newspaper subscribers are those who arrange to have newspapers delivered either by mail or other carrier to their home for a specified period. The subscribers are billed monthly by the newspaper.

Our valuation of the newspaper subscribers is based upon the amount a rational investor would be willing to pay for the subscribers who will continue to subscribe for a fixed period of time. With the passage of time the list of actual subscribers purchased at the valuation date will diminish as old subscribers stop taking the newspaper. New subscribers will not begin taking the newspaper without some effort and expenditures on the part of each newspaper for promotion. Therefore given an expected remaining life for any given subscriber, a rational investor purchasing these newspaper subscribers would be willing to pay only for the value associated with that subscriber over his expected remaining life as a subscriber.

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TESTIMONY OF DR. GERALD J. GLASSER

(February 5, 1990)

DIRECT EXAMINATION

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[51] Q Earlier you stated, Dr. Glasser, that the first step in a statistical research study is to help a client formulate the problem in statistical terms.

What was involved in the first step in the case of the Booth newspaper studies?

A I think I got it a little bit in answering a previous question, but there were several discussions with the clients. It was considerable thought on my part.

There were several internal discussions and the end result followed the talking and thinking was that we would do a statistical study, the end result from which would be a set of mortality tables that would describe the experience one should expect from the subscriptions as of that point in 1977.

That is, these tables which show the expected number of cancellations over the years, the expected number [52] of continuing subscriptions over the years, and enable calculation of such things as, average remaining life of the subscriptions.

Q Now, you also mentioned earlier that part of the work is—in the engagement of this type, is to design an effort to collect relevant data.

What kind of collection data was involved in the Booth newspapers studies?

A There was a large data collection effort. It involved surveys of subscribers.

That is to say, we actually went out and interviewed thousands of subscribers to the eight newspapers and obtained information from them which were then subject to, at a later stage, the statistical analysis.

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[70] Q You mentioned that in technical terms, these relationships are reduced to mathematical formula.

Can you give us in lay terms the essence of what the formulas are about?

A Well, the formulas related to—relate to age, to mortality of whatever elements and the population you are [71] speaking about.

And vice versa, if one has studied the mortality patterns and one would have to study something over time, then they could predict age distribution at any point in time.

In our case we did the reverse. We studied age distribution over time, plugged those numbers into the appropriate formulas and calculated the mortality tables.

Q Is it ccrrect then, Dr. Glasser, you calculated mortality tables directly from the tables on the ages of subscriptions that statistical research collected?

A That is essentially correct.

Q The procedures are described at least in outline form in our report and they are fairly standard applications of statistical method.

Q Does the use of the probability theory that you described imply, and I am asking you this based on your expertise as a professional statistician, does it apply or assume anything about the process by which newly added units are added to the population?

A No. Probability theory is not concerned with the causes of cancellations, and it is not concerned about the causes of additions.

Probability theory or its agent, which in this case is me, is simply concerned with the situation as it exists, [72] and assessng that situation and interpreting that situation, but relies on the data and not on any qualitative judgments or studies of why the population is changing.

Q Dr. Glasser, in your expert opinion can you and other professional statisticians estimate with reasonable accuracy the remaining lives of the paid subscribers of the Booth newspapers as of May 31, 1977 by applying

generally received statistical theories methodologies and techniques?

A Let me say first of all for myself, and the answer is yes, I can, because I did.

As far as other people, I would say that anyone with proper training and background would be able to do exactly what I did.

We have two points that he or she would have to contend to with, number one, the data have to be collected in a way that is acceptable to one of the profession, and number two, you use those data on a favorably straightforward manner, as I did, to calculate the required information.

Q Dr. Glasser, could you describe for the Court how, if at all, the remaining lives of the paid subscriptions of the Booth newspapers compared to the useful lives of the subscriptions?

A I am not sure I am completely qualified to answer.

If there is some technical meaning to the word [73] "useful" or legal meaning to the word "useful," it is beyond me.

If by "useful," you mean the period of time that a subscription continues in force and generates income for a newspaper, then I would say that remaining life is synonymous with useful life and by measuring remaining life, if I would measure useful life—

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CROSS EXAMINATION

[85] Q Exactly, Mr. Glasser. There are two different ways of looking at it.

If you did the study of the mortality tables for the Booth newspapers two weeks after this study, the effective date, say you took the subscription list two weeks later, would the mortality tables be any different?

[86] A If they were different, I would suspect that they would be trivially different.

Q What about a year later?

A Again, I would if somebody asked me if they were any different if I did the studies today, I would suspect they would not be.

Q Exactly.

In other words, if you look at the total number of people you could do your study every year, even up to the present date, 12 years, 13 years later and you would come out with the same statistics that you came out in 1977?

A I want to make sure that is clear that that is an assumption on my part, but I believe we would come out with a very similar set of results.

However, one would want to keep in mind that those results apply to an entirely different group.

The results that we came up with applied to subscribers as of a particular date 1977. If we did a study at this time, it would apply to a particular group of subscribers in 1990.

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[89] Q So those subscribers would have an expected life of 11.93 years still to go?

A Correct.

Q So the table actually says that these—some of the subscribers will still be left 50 years after the purchase?

A Some of the subscriptions.

Q So basically your table just sets out the remaining lives for the subscribers of each of the newspapers from basically zero to 40 years?

A Correct.

Q And, in fact, you state that there would be people still left as subscribers after 40 years?

A Correct.

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EXAMINATION BY THE COURT

[91] THE COURT: What is there in the survey that would [92] indicate to you the number or percentage of persons who would cancel their subscriptions and when they would do it?

THE WITNESS: That is implicit in a study of the ages of existing subscribers, ages, again, in terms of the age of the subscription. That is implicit in the data.

And a birth and death process or renewal process operates in such a way that as in any given period of time, there are some cancellations and some deaths, some dropouts, and additionally there are some additions.

Now, looking at historical circulation data for the newspapers, I was able to observe that essentially the overall number was constant and when I see that, I know how to interpret those age data and construct a mortality table on those age data, but it is implicit in the age data.

The alternative to doing that kind of study is not a feasible alternative at all. That would have been to take the subscribers at a given point in time, and study them for 20 years, and see how we did, and all statistical techniques are attempts to make predictions from the past, and when you—that is all we ever have is the past. We never have information about the future.

So this is, in that sense, a standard statistical application of using information as it exists to make predictions about the future.

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TESTIMONY OF ROGER J. GRABOWSKI

(February 5, 1990)

DIRECT EXAMINATION

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[113] Q Based upon your expertise, what conclusion do you and Price Waterhouse reach as to the fair market value as to May 31, 1977 of the paid subscribers of the Booth newspapers?

A We concluded, based on our investigation analysis, that the total fair market value of the paid newspaper subscribers as of May 31st, 1977 was $60,470,000.

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[114] Q As a preliminary matter, can you explain what are the alternative—might be called basic approaches to valuation?

A Valuation is not an exact science.

Valuation is an exercise of measurement of many factors to arrive at a conclusion.

Value in and of itself is a forward-looking conclusion. It is not a conclusion as to what something was in the past.

People pay money, willing buyers to purchase, willing sellers to sell, based on expectations of the future.

[115] Whenever you are dealing with expectations of the future, you are dealing with one known, so the valuation consultant tries to draw on tools that have been developed, different approaches to try to narrow the gap in his understanding of the various ways that people can look at an asset, can try to measure what they are willing to pay, willing buyer, willing seller.

And valuation theory has really developed around three approaches: An income approach, cost approach, and a market approach.

And it's the goal of the valuation consultant to utilize these tools, these generalized approaches applied to specific circumstances and, by the way, one or more may not

be applicable or it may not be able to apply a specific approach to any specific asset. But utilizes these approaches to try to understand the process people go through in coming up with what purchase price or selling price, because you are trying to simulate the willing buyer, willing seller auction.

This is particularly difficult where you are doing an allocation of purchase price.

You are dealing with a basket of assets for which a purchaser paid one lump sum.

The assets of a business are very interrelated. The assets of a business do not produce oftentimes income, [116] separately.

The fixed assets are interrleated with the inventory, are interrelated were the intangible assets, are interrelated with the personnel, are interrelated with the goodwill.

So it is the valuation consultant's task to use those approaches to dissect the business and associate the value that contribute, each asset makes to that business.

The premise in allocating the purchase price are the values of the assets as part of the ongoing business, not separate, standing alone, liquidating value.

This is a very basic sort of premise that underlies everything.

You see this in inventory valuations. You see it in going back to Jack Daniels and Nap King Size Shoe (phonetic), where the court cases upon which a whole theory of accepted ways of valuing inventories, treat inventories on the basis of their contribution or value as part of the business, not sole naked as liquidated. You see, this is fixed assets.

My classic example I always use is, an old client of Price Waterhouse, no longer a client, but was a client of American Valuations of Price Waterhouse, which was Oscar Meyer.

I don't know if you ever have seen a weiner tunnel, [117] but that is one of the special purpose machines that

they put something in this one end, that some people call meat, and at the other end out comes a weiner.

THE COURT: That is a former client.

(Laughter.)

A And out comes the other end, weiners.

Well, that weiner tunnel, separate from the business, has a scrap value because no one would buy it. It is a specialized value.

Yet, if you are in the meat processing business, making weiners, a weiner tunnel has a very high value. It contributes to the business.

So the valuation consultant has to start with the basic premise that he has a basket of assets. He has a business that generates profits, and try to determine how all of—each of those assets contributes, and therefore those within that confine are the value of the assets as part of the ongoing business.

Q Now, you mentioned earlier there are three basic approaches.

Did you take a moment—would you take a moment and explain what each of the approaches, is please?

A Well, start with the cost approach.

The cost approach is a basic valuation approach that begins with the premise of replacement cost, as being [118] the starting point.

That is, the cost approach says a willing buyer will consider in part of his deliberations, and a willing seller in part of his or her deliberations, what in fact the replacement cost would be of an asset.

Now, we all know that sometimes replacement cost or costs approach—cost approach takes into account the fact sometimes an asset isn't as good as a brand new one, so you reduce the value of full replacement cost for observed depreciation.

Now, the easy one to think of, you can observe the depreciation on my automobile with its rust. So the replacement cost less some observation for depreciation gets you down to a cost approach indicator of value.

A cost approach is based on the premise of substitute, why would I pay anymore for an asset, being a willing buyer, then it would cost me to buy an asset based on its replacement cost.

I use the word indicator because I learned that replacement cost doesn't necessarily mean value, and this can go both ways.

For example, just north on this side of the Hudson River, just north of the New York/New Jersey border there is an office complex. I don't know what it goes under now, but it one time was called the Blue Ridge Office Park.

[119] It was a large development, and I know because I was involved in the valuation as it has regards to some bankruptcy.

There was a complex of office buildings that had a replacement cost new, and in fact had just been constructed, which were in excess of $30 million, between 30 and $50 million. Willing buyers presented with the opportunity of buying that office complex, acquired it for less than $20 million.

The replacement cost wasn't indicative of the earning capacity of that asset.

You read about it today in—for example, Houston, you can by office buildings within the last five years that were constructed for two or $3 million and the Resolution Trust Company would be very pleased to take a number far less than that. In fact, I know of sales of less than $50 million.

So that is one, where you see income, somehow puts a cap, income generating potential puts a cap on replacement costs, an indicator of value.

Let's go to the opposite side. I know of an example because it happened to be a relative of mine, where a small chemical company, small chemical company had a chemist out of school, the chemist out of school stumbled on an invention.

[120] That relative sold that business for many millions of dollars.

What was the replacement cost of the patented invention?

It was negligible relative to the value, so replacement cost is just an indicator.

Secondly—second approach, and I will go right into it now, is the income approach, and these are not necessarily preference between income and market, the next two.

But as I indicated from the top and bottom, that is, up and down from replacement costs, what generates or drives value is expected income, expected profits, expected flow.

These are concepts that drive value.

The income approach is the most true—the most truly indicative measurement of value, because that is really what people are willing to pay for is the—in an investment asset, is the income generating capacity.

The last approach is the market approach.

Going back to the income approach, the income approach when I talk about it, it's taking the capitalization or the present value of expected future income, you see this with buying an apartment building, buying a trade name, buying a business, is the [121] capitalization or present value of future.

The last approach that we use is the market approach. The market approach is one where you try to find observations of market transactions.

Now, sometimes you can, sometimes you can't. May be very difficult to find observations of market transactions for any one specific asset.

But what is always important to remember is that, the market approach is really a reflection of how people feel or their measurement of the income-generating capacity of an asset.

Use an apartment building, as an example. An apartment building you can observe market prices for apartment buildings.

But really what is driving market prices is capitalization of income. That is what makes market prices go up and down.

The market is the consensus of willing buyers and willing sellers about income, expectations.

So if you can observe the market approach, it's really an—or market observations, I use the apartment building as the example with kinds of observations that people have.

I have reason to discuss in the last day or so rules of thumb of businesses, accepting to be rule of thumb [122] we are discussing about beer distributors.

Several years ago, ten years ago, the rule of thumb was between two-fifty and $3 a case, was the fair value of a beer distributor business, that is, you took the annual cases of beer sold by that distributor times this rule of thumb price, and that was the rule of thumb market value.

Today, that rule of thumb is in excess of $5 a case, but those are just broad guidelines.

That doesn't mean that that is the correct price for every beer distributor.

The market price is simply these rules of thumb that people use to value businesses are sort of an average of what people see being paid for those kinds of businesses, based on analyses that willing buyers have done and willing sellers must have done to accept the price.

• • • •

[123] Q Mr. Grabowski, before the luncheon recess you explained each of the basic approaches to valuation.

Can you explain how an expert appraiser determines which approach to utilize in particular evaluation exercise?

A Well, when approaching any evaluation, an evaluation consultant really looks at it from the standpoint of constructing an evaluation of model of some sort.

Remember, we are dealing particularly in an instance like this one, with valuing a group of assets.

That is, there was a lump sum purchase of assets, and our goal is to associate the various values of the assets as they contribute to the overall income generating capacity of the business.

So in looking at each and every asset, an evaluation consultant looks based on his experience and study of the specific assets which have the valuation techniques, first of all, he might be able to apply because of data availability.

For example, for the paid newspaper subscribers of the Booth newspapers, there is no market for paid newspaper subscribers apart from buying the business.

[124] You can't go read The Wall Street Journal, and there is a quotation for paid newspaper subscribers.

And by the way, you can't read The Wall Street Journal and find a listing for a quote for a weiner tunnel either, so going back to my previous example, so you say that there are no direct observations you can make for certain assets out in the market, special assets that have contributory value to the business, which don't sell necessarily separate from the business.

So you discard the market approach in these instances, and then you examine the other two approaches, cost and income.

Now, the question arises from the cost approach, which again is just an indicator of value, can you design a valuation model that captures what really is the replacement cost of the assets you are looking at.

For example, if you were valuing computer software, some computer software is very straightforward. It's the number of lines of code, how many lines of code does it take on the average for your systems people and programming people to come up with per day, given historical analyses, but sometimes what is embodied in a computer system has really little relevance to the historic mantime that may have been placed on it.

This can be both from the—again it can be up or [125] down. It may have great value relative to the

number of hours of Lotus one, two, three, a popular software package that is sold.

Clearly that software package has value far in excess of the manhours that were taken to code the software, and on the opposite side I have seen software where the number of manhours that have been expended trying to develop a software far exceeds the value.

Why? Because they made mistakes.

In trying to construct evaluation model from the cost approach, descending on the assets it can be very difficult.

In the instance we are here, were paid newspaper subscribers, we are dealing with newspaper subscribers which have certain expected characteristics. They are seasoned.

That is, they are not all the new guys on the block, the first time taker of the newspaper, and therefore trying to just use the cost of a solicitation as a single number, I solicited—I got solicited to take the newspaper for 13 weeks, because I got a teddy bear kind of promotion around Christmastime for—in the Chicago area for newspapers, some sort of stuffed animal with a 13-week subscription.

You have to get many, many of those first time subscribers to take the newspaper before you can create a [126] comparable group of newspaper subscribers, a comparable—comparable newspaper subscribers with the same expected characteristics for useful life for how long they are going to take the newspaper.

I will give you another example. I see this done with a number of mailing lists, and I see that this is a common way of building a mailing list by renting other people's lists, and then sending out catalogs until you get a response.

Because when you are building a mailing list, you rent other people's lists. I am sure we have all gotten something, where you look at the label and say, oh, I can tell that I—that list I was on that subscription list or that

credit card list, American Express sold my name and now I am getting mailings from somebody.

It takes many, many mailings. Some response rates are half a percent to five percent, just complete success. That is considered unbelievable success.

But a half a percent of a million names for someone to just say, yes, I want to be on your mailing list, so if I were to begin one, and I went out and solicited new participants in my mailing list by mailing one of my catalogs to all of the list of names off the American Express, I may come up with a half percent, one percent response.

[127] And then I still don't know if myself as a respondee will have the same sort of buying characteristics or future repetition response, but I do know that it takes many solicitations to get a respondent who has characteristics of someone who is already proven to be a seasoned respondent or seasoned subscriber.

Q Now, in preparing plaintiff's number three, which have the three basic valuations approaches, did you utilize—

A After looking and discarding the market and after discarding really the cost approach as an easy way of coming up with what value construct, model built around it, we use the income approach.

Q When you prepared your earlier report dated May 4, 1979, while at American Valuation Consultants, Incorporated, did you utilize any other approach in addition to the income approach to value the paid subscribers of the Booth newspapers as of May 31, 1977?

A Yes.

Back in May, of that report of May 31st, 1977, I did attempt to build a valuation model around a cost approach.

But again very artificial, because you can't say here is the cost to acquire a seasoned subscriber. I can tell you what the cost is to solicit a new one, give us a teddy bear in 13 weeks and you can get somebody to sign up.

[128] But he—that subscriber does not have the same life characteristics of a seasoned repeat subscriber.

Q Now, why did you conclude that you would not use that cost approach in the valuation report presented with your testimony today?

A Well, first of all, it was 13 years ago and I am a lot smarter today, and I put it together at a time to attempt to measure, to try to represent additional evidence as to the value of the newspaper subscribers.

It was an artificial model construct at that time, because I am trying to capture something that is not easily captured, and I felt it was really too difficult to explain.

So even though it supported the value that was derived from the income approach, I felt that it was artificial in its construct, its construct and certainly inferior to the use of the income approach, I felt that then that is why we did not use it again.

* * * *

[132] Q Let me ask you, Mr. Grabowski, are the valuation principles that you have just described that you used in this valuation exercise, ones that you applied uniquely to this case, or are they generated-accepted principles within the community evaluation experts?

A They are certainly not unique for this as far as my application of them.

And they are not unique as far as my knowledge of other people's work is concerned. It's a very commonly accepted approach.

I know this because through my role at Price Waterhouse, we have many tax and audit clients that have had over the years, and continue to have their valuations performed by other valuation consultants besides our other people at Price Waterhouse.

As part of my role I am called on very often to review the work of other people, the methodology, the theory that we have applied here is very consistent with the

generally accepted valuation theories being used to value paid subscribers.

* * * *

[137] THE COURT: Let me ask you this first.

Why in column seven do you only have reference to the collection cost? Why do you not include the production costs of the newspaper?

THE WITNESS: If your Honor—your Honor, if you think about the model that I described, evaluation model, and you look at the alternaitve method of operating a newspaper, one is paid circulation newspaper for which there will be revenues minus collection costs.

And the other is a free distribution newspaper, where there is editorial contents, paper, there is all of the other costs, the only difference between these two is the marginal revenue minus the marginal costs that the subscribers bring to the paid subscription payment.

* * * *

[139] THE COURT: I understand that. I am saying, what about the cost of the paper itself to the company engaged in delivery?

In addition to the cost of delivering it, they have to purchase the newspaper, either the newspaper has to be published by the company distrubiting or bought by the company engaged in distributing it. You don't get it free.

THE WITNESS: I agree.

If I have a company and I could run my publication having subscribers or distributing it free, the added value from having the subscribers to me as a publisher is the revenue net of expenses of collecting the cost, and by the way, revenue is net of the delivery costs, that is the actual revenue being received by the newspaper.

That is the difference in incremental revenue as publisher of the newspaper is how much I receive from these subscribers net of the incremental costs that I have.

[140] Even if I am getting it free, free distribution, a reader, for example, there is paper, editorial costs, they have to solicit advertising, all of those costs are still there.

The difference in its valuation model of how you incrementally say, what does this asset add to the value of the business, is the incremental revenue that these subscribers contributed to the Booth newspapers over their remaining life.

THE COURT: In the hypothetical I gave you, distribution was separate from the production and publishing of the newspaper, in valuing that company, distribution company, you would certainly deduct the cost of acquiring the newspapers as well as the cost of delivering it.

THE WITNESS: Yes, but I would do it for both cases whether it was a free circulation paper—I would have to get my revenues somewhere.

Presumably, if I was a distribution company, I was collecting money and paying something for the paper.

If I were strictly a free newspaper, if that was the service I was providing to the publisher, I would distribute it free, but I would be getting paid directly by the publisher from his advertising revenues.

So in either case, I would—I, as the distribution company, would be receiving it.

* * * *

[143] Q In that context, Mr. Grabowski, how would you—looking at it hypothetically as opposed to a particular newspaper, how would you confine, in your estimation, the expense categories of the two comparable papers, one being a free circulation paper and the other being a paid circulation paper?

A Well, in the valuation model we built, we had with the expenses, other than those associated with collecting the revenue, that was the difference in the expense because both types of newspapers would have—would have editorial content.

Q What kind of expenses are involved in having editorial contents?

A Paper, writers, photographers, people that go out and solicit news stories to put in the paper, cover news stories in both instances.

[144] I am not talking about newspapers here that have world-wide news bureaus one become another.

I am saying there are two ways of operating, and the difference between these two operations is the—is the marginal revenue that is associated with the newspaper subscribers—

Q Looking again at the two—the mode we will use, the term comparable one being a free distribution paper and one being a paid circulation paper, which of those would have the expenses of say pressman, for example?

A Both newspapers.

Q Which of the two examples would have the—which of the two papers would have the expenses that—say an advertising sales force?

A Both of them. Advertisers don't come in without efforts.

Q Which of the two papers would have for example the expenses related to delivering the newspaper, say, from the point of production to the point of distribution?

A Both of them.

Q What revenue—what would be the differences in the revenue streams of the two institutions?

A The free paper would not have subscription revenue.

The paid circulation paper would have subscription revenue.

[145] Q Assuming for the moment you were looking at two papers in the same community with the same distribution and the same kind of advertising contents and the same kind of editorial content, what expenses would one paper have that the other would not?

A Oh, cost of collection, certainly, because in order to get the revenues in, I have to go and have some effort to collect the costs, and if that is part of the expenses of the newspaper, and that happened to be how this was operated in the Booth chain, is Booth itself and the people that went out and collected, I had to deduct it. The collection people didn't keep a slice off the top of the revenues.

Okay.

Q Could you explain to the Court why in your expert opinion, this particular methodology that you used results in the determination of the fair market value of the paid subscribers of the Booth newspapers as of May 31, 1977?

A Well, we used the income approach. And in my experience, the income approach is the way that willing buyers make decisions on purchasing assets that they are holding for investments or to generate income.

However, I know this, during the time that I have been at Price Waterhouse, much of the work I do is assisting buyers and sellers of companies determining—buyers and sellers of assets, determining how much to pay or how much [146] to see as an offer, for a specific company or asset.

And my observations, that these decisions are based on income measurements, and therefore we have applied a method that parallels the world of decision-making, and that is what is the income generating capacity of a specific asset.

* * * *

[147] By the way, your Honor, one other way, as I am sitting here thinking and trying to formulate an answer, if you had two newspapers, forget that they are a shopper, for example, let's go to a daily that the principal distribution is the coin box, it doesn't have to be free versus pay.

It's the difference between the value of the circulation that is paid in the coin box versus the revenue that is distributed or received from a subscription.

We are not valuing the coin box revenue. I could have a newspaper that that is how it's distributed.

USA Today is basically a coin box distributed newspaper.

Paid subscribers have characteristics of longevity, of measureable life that say this subscriber has [148] expectations, I am going to receive extra revenue from

them, a lot stronger than the revenue that I may get from his putting a coin in the box.

* * * *

Q Can you explain for the Court whether based upon your expertise, you reached any conclusion as to whether the paid subscribers of the Booth newspapers was set separate and apart from the goodwill of the newspapers?

A In my opinion, they are separate from the goodwill of the newspaper.

Q How did you come to that determination?

A Well, first of all, they have a useful life that is determinable with reasonable accuracy.

Second of all, they have a revenue, an income that is measurable, that is identifiable with those assets.

In my experience, in my opinion, the two characteristics, the combined characteristic of estimable useful life, reasonable determinable with reasonable accuracy, and directly associated and measurable income from those assets, lead me to believe that I have identified and separated an asset from goodwill.

[149] That to me, in my experience, in my opinion is a test.

Q Based upon your expertise, Mr. Grabowski, how would you define the reputation of the newspaper such as the Booth?

A Reputation and integrity, those are elements of goodwill.

I am not saying that goodwill can't influence assets or values in a business, and in fact, goodwill—in valuing the assets in an allocation, your Honor, this is their interplay in the business of all of these assets, and goodwill can influence the value of other assets as well as other assets can influence the value of goodwill.

* * * *

[152] THE COURT: Let me ask you this: if the average company that has retail sales of a customer, you certainly would not in the typical case take the average

prior years, whatever it is, net or gross sales and say that is an independent asset separate and apart from goodwill, would you?

THE WITNESS: No.

THE COURT: Ail right. What is there about subscriber lists because they are indeed, they are the customers of the product, are they not?

THE WITNESS: One category of customers of a product.

THE COURT: Is it a fact that they are predicted to continue on one of the items that distinguishes this from the mass of consumers that buy a particular product?

THE WITNESS: They are individual people who have a predictable characteristic of return. That characteristic is something in the real world people are willing to pay [153] for.

That is an asset of value in the real world, predictability, returnability.

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[155] Q In your expert opinion, what is the appropriate method of determining the value of the goodwill of an enterprise such as the Booth newspapers?

A My opinion, the appropriate opinion for valuing goodwill [156] is the residual approach, that is, taking the purchase price or fair market value of the entire business, subtracting the value, all of the identifiable and acceptable assets and the amount that remains is the goodwill. Sometimes concerned value gets thrown in there, but that is goodwill.

Q Why is that the correct methodology from a pricing or—standpoint?

A Goodwill, there is no concise formulation of how you measure specifically goodwill.

If it's integrity and reputation, those are nebulous, and once I get all of the assets that I separated from goodwill, what is left over has to be unassigned or unassociated with anything and represent the excess earning power that

people were willing to pay for and traditionally, excess earning power has been used as a measure of goodwill.

Not being defined as goodwill, but as a measurement.

Q Based upon your experience, Mr. Grabowski, what is the Internal Revenue Service's view of that methodology of viewing the goodwill of an enterprise?

A Generally that is the method the IRS prefers, even prior to the current change in the current tax law.

Current tax law mandates the residual method at the behoval of the IRS of that being the method. Prior to that time my experience was that most of the time that was the [157] position that the Service took was the—that the residual value was the correct method.

• • • •

[159] Q Based on your expertise, could a free circulation newspaper have goodwill?

A Certainly. Can have reputation, integrity, people—can have all of the kind of elements.

It can ruin its goodwill just like paid circulation can.

Q Again, based on your expertise, how would you respond to the Government's contention that the paid subscribers of the Booth newspapers are not the appropriate assets to be valued, but if any assets should be valued, it should be the subscription lists of the newspapers?

A Well, certainly that is not what people are willing to pay for lists of names and addresses.

What people are willing to pay for are the expectations of measurable and estimably—estimated with reasonable accuracy useful lives and revenue streams being generated. This is the principle that in the Citizens in Southern case was used.

I valued core deposits for a number of financial institutions. That is the principle that here is a preditable amount of the deposits called core deposit base. [160] It wasn't the value of the list of the people that were depositors.

It was the income that was being generated. That is what we are valuing here.

Q Based upon your expertise, how do you respond to the Government's contention that kind of the real assets of value in this case is what they call the customer structure or subscription structure of the Booth newspapers, and that that assets lasts essentially forever, or is what is sometimes called self-regenerated?

A Well, first of all, anybody who knows anything about publication and the solicitation that goes on to attract new subscribers, and this is true in varying degrees with all types of subscribers, very rarely do you find something that quotes itself regenerating. People have to make efforts.

I tried to think of an example and one struck me when I got off the airplane driving past Anheuser-Busch brewery.

Don't think all I do is think about breweries.

(Laughter.)

A That is a brewery structure. Five years ago it looked the same. Five years from now, it will look the same.

But inside it's made up of individual machines, individual tanks. The machines five years ago that were there, some have been replaced, others will be replaced in [161] the future. Over a time spectrum, you can think of a brewery as being a brewery structure.

And yet the equipment from today and ten years from now is not going to be the same equipment.

These ten years from now, if everything that was estimated in terms and the stability that was experienced, et cetera, I would want paid—again going to my first thing, that the Ann Arbor News data would have daily subscribers, but they are not going to be the same subscribers as the 37,744 that were acquired on May 31st, '77.

Just as much as the fixed assets in that brewery are not going to be the same ten or fifteen years from now.

• • • •

[162] Q If one were to carry your analysis and this may be a little repetitious to some of the questions the Court asked, but let me ask anyway to be clear.

If one were to carry your analysis to its logical conclusion, would that mean that the customer's structure of all businesses would be depreciable?

A No. Their are many businesses.

Your Honor used the example of a retail.

I happen to have—my wife and I have patent in a chain of bed and bath linen shops in the Chicago area.

We have customers that come in every day to buy sheets and towels, but we don't know if they are coming back.

I would hope so, based on the reputation. I have no way of measuring that. They are not acceptable to me [163] from the goodwill of the business, because there is no way I can identify them, other than seeing their face when they come in, but I don't know when they come back.

There is no way of predictability. So certainly, in that example, that customer and they have customers, there is a customer structure. So this is, in my opinion, a fact and circumstance issue. This is not an issue of that, is the same in all circumstances.

We used the newspaper before where we had with the circumstance of puttting the coin in the box. That was the principal method of circulation. People do, people don't.

I can't identify who those people are. Therefore I can't separate them in the traditional generally accepted methods of determining a value and life of an asset to find an asset that is separable from the goodwill.

I have no easily determinable useful life and I can't recognize a revenue associated with that asset with that —with those customers to our retail stores.

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CROSS EXAMINATION

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[169] Q What asset did the corporation—the Booth newspapers hold evidencing a relationship with these paid subscribers?

A The past commitment of these subrscibers to take the newspaper, their current agreement to take the newspaper, and Booth had a likelihood that these people would continue taking the newspaper within a reasonable degree of accuracy.

Q So they had a relationship with these subscribers, that is the most you can say, isn't it?

A The subscribers had made a commitment to take the [170] newspaper.

Q So the Booth newspapers had a commitment, is that what you are describing as this asset? You are depreciating a commitment?

A No. Depreciating paid newspaper subscribers.

You asked me how it was evidenced. It's evidenced that they were committed to take the Booth newspapers.

• • • •

[178] What I am showing, and I will continue to show that the Booth newspapers could have solicited every household in all eight areas under Mr. Grabowski's formula, $4.50 per household for a total of $3,300,000, every household in all eight areas, a total of 724,400 households.

I am saying that he rejected the cost approach.

Q I want to know why when you you could have solicited every member of the original subscription list for $3,300,000, why you rejected the cost approach.

THE COURT: I will overrule the objection.

MR. TURKUS: I will withdraw my objection to that question.

A Because the valuation issue at hand was what is the value of the newspaper, the paid subscribers, and I will use your Ann Arbor as an example, which and quoting from the report because there is an example in the report, has a remaining useful life for daily subscriber in Ann Arbor of [179] ten years.

So the question was: What was the value of a subscriber whose on the average remaining useful life is ten years.

The cost approach of soliciting for the first time is very similar to the example I used of building a mailing list, where I have to solicit again and again and again to get people to accept a commitment—making a commitment or expectation that they will take the newspaper for ten years.

I have no way of—this was an artificial construct, artificial model that I developed to try to bolster the value conclusion that the income approach had resulted—

THE COURT: Well, Mr. Grabowski, let me do to Mr. Hrebiniak that I have been doing all morning to Mr. Turkus.

If we go back to your comparison of the newspaper fairly identical with paid circulation and the giveaway, the Shopper, if all it takes to convert the Shopper into the paid subscription is the expenditure of $3 million to acquire that paid subscription list with the expectation that if you got the same subscribers, they would continue as they would continue under your present model, why isn't that the proper approach to take?

THE WITNESS: Because, your Honor, the issue in my mind is, and I understand this is not an easy issue, and it [180] has taken me some time to formulate it.

The issue in my mind is I could start a newspaper somewhere, forget where they are for a minute. Say there is a city with no newspaper.

I can start a newspaper, paid or free.

I know that if I have a paid—free circulation newspaper and people became accustomed to reading it, I will solicit them to started taking subscriptions.

Some people will say I liked it a little, but not enough to pay money, so you will pay an inducement.

Some people will take the inducement, take it for 13 weeks and say, "I didn't like it that much."

You will have to induce and induce and induce again some portion of that population until you can simulate or you can reestablish the same commitment to pay money, it isn't just reading it. It is the commitment to pay money for the newspaper with the same predictability as what was acquired in the Booth newspaper situation.

THE COURT: Why would there be such a tremendous discrepancy between the value you placed on it and the cost, I will not say replacement, because it is not replacement, but really of creating it?

THE WITNESS: In this report, if I can quote, the concluded value that I had for the cost approach was $40 million by the way, your Honor.

[181] The way I built a model, which I was never satisfied with at the time, but which helped—if you remember, your Honor, the questions that the appraisers tried to use a couple approaches, if they can, the conclusion of value is that I used as the cost approach was in excess of $40 million.

That is what was—what I estimated at the time would require this repetitious buildup of a group of subscribers, of individual subscribers that had the same characteristics.

Now, let me go back again for a second to the mailing list example, because I find that this sometime is useful for me to understand.

I have to solicit millions of names to get a million names. I might have a point five percent, first by—people will—you get mailers from people with a new mail order catalog. You may get the mail order catalog five times before you ever respond, if you ever respond.

It takes a lot of efforts of resolicition to build the predictable commitment that these newspaper subscribers have, and that is what I tried to construct in the cost approach as I had them.

And as I said, when Mr. Turkus asked me the question why did I change, I said I am smarter today.

It isn't that I couldn't come up with what [182] construct or model that gave me a number, but it was an artificial way of trying to regenerate something. This asset, newspaper subscribers with characteristics that I couldn't go out and buy.

I can't go out and buy newspaper subscribers with predictable characteristics to read the Ann Arbor newspaper daily for the next ten years.

* * * *

[184] Q Now, the other thing is that you have taken all of the marginal income, as you call it, and we will get into it later, from these subscribers, and you have allocated absolutely none of that to goodwill, is that correct?

A I don't know what you mean.

Q You have taken all of the marginal income from these subscribers, every cent of it, every fraction of a cent of it, and attributed it all to the newspaper subscribers who you say is separate and apart from goodwill. Is that correct?

A We have taken the present value, not all.

Q Present value?

A Minus direct cost.

Q You have taken none of it, not even a fraction of one [185] cent have you distributed to goodwill.

MR. TURKUS: Is there a question, your Honor.

Q Have you?

(Laughter.)

MR. HREBINIAK: Thank you.

A We distributed revenue minus marginal to this asset.

Q None to goodwill?

A Goodwill based on the residual approach back—you can look at the report, was 77 million.

Q None of the money to goodwill?

A No.

* * * *

(February 6, 1990*)

* * * *

[336] Now, summarizing the income approach you took the revenue generated per subscriber.

Now, that is the actual amount that they paid for a newspaper, correct, per day?

A. No. That was the actual amount that was received by the newspaper.

Q I should have finished.

The gross revenue then was the amount that they paid, 30 cents a day or back then, probably 15 cents a day, is that correct?

A That would be of the gross amount that they paid, whatever the correct amount was. I do not recall.

Q And then you would subtract from that amount, the cost of delivery, and then eventually you would subtract from [337] that amount the cost of collection, is that correct?

A We took the net revenue that was received by the newspaper, minus the cost of collection.

* * * *

[345] THE COURT: Suppose you have an office in the newspaper, a subscription department, I do not know four, five, people, they are taking up a 20-by-20 space, how does that figure into the calculation?

THE WITNESS: Your Honor, I would have to go back and review exactly how we calculated it.

We took into account the expenses for those personnel, and I think it included—I, quite frankly, don't remember the totality of the expenses.

But any directly-related expenditures to the activity of billing and collecting the money, so if there was, for example, and I deviate that from the controller of the newspaper, you know, the accounting department of the newspaper, where those—just general bookkeeping, we do

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* The remainder of Mr. Grabowski's testimony is reprinted out of chronological order for the convenience of the reader.

[346] not include any expenses related to that. Because in both instances, the controller's department would have been there, whether it was a free distribution or a paid distribution newspaper.

THE COURT: So, in other words, under those circumstances, you would distribute nothing in the way of overhead expense to delivery and collection from the paid subscribers?

THE WITNESS: Your Honor, I would have to reread what exactly we—what was said both in the report and when we did those calculations back in 1977 in the consultant evaluation reports.

BY MR. HREBINIAK:

Q I certainly would appreciate receiving that information myself.

Isn't it a fact that basically what you did was calculate that the subscription price is approximately 15 cents per day, and from that you subtracted what the newspaper actually just delivers at the dock to the distributors who were independent contractors, which is two-thirds of the price of the newspaper, isn't that all you did to calculate the delivery costs?

A We took into account whatever the net revenue was that was received by the newspaper.

* * * *

[350] Q All right. Okay.

So when the—when a newspaper then is delivered to a customer who pays for that newspaper, there was nothing actually deducted out of this revenue stream for the cost of that newspaper. Is that correct?

A Which costs of the newspaper?

Q Of producing the newspaper. Physical product itself.

A You mean the—is this the paper, is that one of the costs you are speaking of?

Q Well, what are the costs—yes. That is obviously one of them, the costs of producing the newspaper?

A Okay.

No. Because in the difference between a free distribution newspaper and a paid distribution newspaper, paid subscription newspapers, the newspaper costs, printing editorial, et cetera, would be there in both instances.

Q But you know, we are really not dealing with the free newspaper here.

As a matter of fact, are there any free daily newspapers in the country that you know of?

A I don't know of any.

• • • •

[354] Secondly, advertisers actually pay more for advertising, where there is a commitment on the part of paid subscribers to take the newspaper.

[355] I don't know how much more they did. In fact, I tried to study that, and it's inconclusive from the evidence that I have been able to piece together at the time.

How much more advertisers are willing to pay, because you, as a reader, have put down money, so if anything, by not including advertising revenues, this incremental amount of advertising revenues, that I could not specifically quantify. If anything, I felt that maybe I even underestimated the revenues generated by having paid subscribers.

But I did know that I could have if there were no newspapers, I could have a free—in a specific area, I could have a paid or nonpaid circulation daily.

It turns out that I don't do it because I like the revenue of a—have the paid circulation, I like that revenue, it's a benefit to me.

If I can establish myself as a paid circulation newspaper, I am increasing my revenues.

Yesterday, your Honor, we talked about, you know, the idea of bringing in more of these revenues.

These revenues to contribute to the profit of a newspaper.

It's not that I don't like them. It is if the guys that have already been in a marketplace sort of put their stakes down and gotten people to commit, and I am a new [356] player on the block coming in, I am going to break into the market with a free newspaper, later try to convert it to a paid newspaper, because that is extra revenues.

But in the sense of I am still delivering the product, I am delivering the advertisers' message, and they are the principal source of revenue of paid newspapers.

• • • •

(February 7, 1990)

RE-DIRECT EXAMINATION

• • • •

[399] Q Mr. Grabowski, you were asked questions I think on Monday, and in fact you just heard colloquy of counsel concerning it.

In your 1979 report you utilized the cost approach in addition to the income approach to value the paid subscribers of the Booth newspapers as of May 31, 1977.

Can you explain briefly the methodology you applied in usig the cost approach at that time and the rationale that was underlying that methodology?

A Well, as I spoke now going back, I think till Monday, about the desire, if possible, for an appraiser to use—or [400]valuation consultant to use multiple nothings, I recognized the difficulty of trying to establish an estimated replacement cost for newspaper subscribers that have certain life characteristics, certain expectations in the future.

For example, I think in the statistical research report, I recall that Ann Arbor's—the useful life of the Ann Arbor's subscribers from the report was ten years.

I recognize that I can go out and obtain subscriptions from a solicitation house.

They would go out and canvass the people and get me subscriptions.

But if I were starting a newspaper in a marketplace, and I think I recall I used $4.50 as the solicitation cost would just get me a 13-week subscriber, they wouldn't get me a ten-year subscriber.

So if I started, I would just get a 13-week subscriber.

So I attempted to estimate what it would cost me, knowing that if I acquired the Ann Arbor News, I obtain subscribers that I could predict a ten-year useful life, what it would cost me as the willing buyer to ensure that I could get ten years worth of subscribers.

So I analyzed what it would cost over a period of time, going back, knowing the churn, as I understand it, that is, people who take the subscription for 13 weeks and [401] say, "Well, send me another teddy bear."

And I analyzed it by dividing the 10 years into a 13-week period and how much I would have to spend every 13-week period, knowing the churn to ensure that I had 10 years worth of subscribers.

I analyzed that to the present value of that cost, and that was the replacement cost, as I think I quoted sometime before from having read the report when it was handed to me, the total estimated replacement cost value, indicator of value is in excess of $40 million.

Q Now, you also indicated in prior testimony, I think on direct and also on cross-examination, that you did not utilize cost approach when you prepared the report which has been accepted as Plaintiff's Exhibit 3.

Why did you conclude that you would not use the cost approach when you prepared that report?

A Well, first of all, I felt it was very artificial. I don't know what it would cost me in a true sense to go out and replicate or reestablish a ten-year relationship with subscribers. I don't know that.

So I made up a model which I felt was—which could have some problems with it.

Since I did that report, I also learned that courts in the United States have recognized that the income approach is the appropriate method of—the income approach

[402] as the accepted method of valuing intangible assets like the paid newspaper subscribers, and I accepted that that is the—theoretically I knew that that was the correct approach, and I accepted that that is the best way of presenting the evidence as to the value.

* * * *

[404] Q In that hypothetical scenario we are talking about, if you assume for a moment that the buyer could reestablish the relationship with all of the prior subscribers over some period of time, in your expert opinion would the cost expended in that effort, if we assume it was $4.50 a household the way Hrebiniak posited it, would those costs represent the full and complete cost of reproducing the subscribers that you had as of May 31, 1977?

A No.

As I stated, the—I attempted in the cost approach model to simulate that idea, and that was to start over again.

Now, I am an investor. I can go to a market with no newspaper, start a newspaper, or I can buy a newspaper with subscribers and pay for that asset.

I went and said, what would it cost to—what would it cost me to—to—to—to initiate that.

I quite frankly don't know. It happens over long periods of time, and I know a lot of money is expended to [405] get paid subscribers with a certain life character over time, and the reason the money—because—I will use the word churn again.

Q Would the solicitation effort, the cost of that solicitation effort in that hypothetical, in your expert opinion, represent the fair market value of a paid subscriber of the Booth newspapers, whatever the cost was, would the cost of reestablishing those relationships represent the fair market value of the paid subscribers, if you could determine what the cost was?

A No. As I testified before, the cost was simply an indicator of value.

The income approach is the appropriate method of valuation.

I used—I think I could use the example of a—happened to be an uncle who had a company and had a chemist that invented a patented product.

You have—all of a sudden there was a company worth millions of dollars.

The incidental salary of three months' worth of a chemist is—hardly equates to the cost. Similarly, the coding of Lotus 1, 2, 3, development cost, which is a very popular software package—the software package alone is worth millions and millions of dollars—just doesn't reflect what somebody might come up with as the replacement [406] cost, so cost and value are not synonymous.

* * * *

[408] Q Have you had an opportunity or on the evening recess to review your records about what costs were subtracted or offset?

A Yes, I have.

Q Can you explain to the Court—having refreshed your recollection, what it was that you did subtract?

A We subtracted, your Honor, the salaries and fringe benefits and the direct expenses of the district managers and the cashiers and the extra help with regards to collection.

[409] The district managers perform many functions besides going out to the newsboys and collecting the revenue.

The expense that the newsboys have of collecting the revenue has been reduced from the amount of the subscription revenue that the newspapers have.

The district managers perform many functions, and I substracted all of the costs of the district managers.

Q Now—

A And these other support people, the principal people involved with the district managers.

THE COURT: But all experiences directly related to collection?

THE WITNESS: Correct.

THE COURT: But again no production costs, nothing to do with the production of the newspaper itself?

THE WITNESS: No, your Honor, because whether they collected one dollar of revenue or no dollars, there would be the production costs of producing a newspaper.

Q Now, there was some dialogue, I think it might have been yesterday between you and Mr. Hrebiniak, might have been the first day, about delivery—allocating or deducting delivery costs, and sometimes he used that terminology and sometimes your answers talked about what we attributed to the subscribers was the net revenue received, but there was [410] a dialogue sometimes delivery costs was used and sometimes net revenue.

Can you clarify for me what is confusing in the record for me on that?

A Well, if the delivery is made by someone who picks up the newspaper at the dock, we did not subtract any delivery costs, because in the price the newspaper receives, there is a deduction already for the delivery costs, so the delivery cost is implicitly deducted.

Similiarly, if it's delivered by Booth to a distribution point, we did not subtract delivery costs because a free newspaper would have to get the newspapers out there anyway.

So in both instances, we have left the delivery cost to something that is then—been absorbed by the newspaper, other operations, not by the subscribers.

Q So to the extent you may have said you deducted delivery costs, you meant in the context of somebody who came to the paper and picked it up and did the delivery themselves, by attributing all the income the paper got from them, there was a netting out of delivery charges. Is that correct?

A Yes.

Q But you did not actually allocate against or offset, subtract from the subscription revenue stream that the paper actually received any delivery costs?

[411] A No. Because those expenses would be there regardless of whether the newspaper was free or paid.

Q Now, you testified that you did not allocate a portion—you did not allocate any production costs—in fact, you just answered a question from the Judge about that a moment ago—to the subscribers as a subtraction from the subscription revenues.

In the model you used, in your analysis where did those costs get allocated?

A To the advertising revenue.

Q Why is that the case here?

A Well, the first item that an appraiser has or evaluation consultant has to do in applying the income approach is understand the principal source of revenue, why are these expenses being expended, what generates the revenue.

The principal source of the revenue in newspapers are the advertisers.

They pay to obtain their advertising, to put—have their advertising placed in front of the readers.

You then look and see if there are any by-products. The subscription revenue minus the additional revenue the newspaper receives from subscriptions, minus the additional expenses is really a by-product of the activity of delivering the advertiser's message to the reader.

We took the additional revenue minus the additional [412] expenses. That present value is the basis for the fair market value.

This is a common accepted method where there are by-products to a principal function.

Q Can you give the Court any examples of other valuation exercises, where valuation experts would agree that the correct way to determine the value of an asset is to determine the present value of the additional revenue

brought to an enterprise by that asset without allocating any costs other than additional costs, as a subtraction or offset in that revenue stream?

A As I left the hotel this morning, one struck me which was looking across the street at the Pennsylvania Railroad Station, New Jersey Transit and Amtrak are in the business of running trains.

I also noticed that they have leases, at least with Mc Donald's, for example. The value of that lease of having Mc Donald's in there is the revenue received from Mc Donald's minus whatever additional expenses there might be.

The Pennsylvania Station, Downtown Newark, would be there regardless.

We don't subtract an allocation of the maintenance costs of the track from the revenue that Mc Donald's generates for New Jersey Transit and Amtrak.

That is a by-product of having the station. That [413] is the value of that lease.

Another one that came to mind was—if I were a manufacturer of newsprint, and I have a large boiler generating steam for my newsprint manufacturing operation, I may enter into a contract to sell the excess steam to a power plant. This is a very common popular way of generating—generating additional revenue.

The additional revenue is this by-product generates minus the additional expenses would be the value of that contract with the utilities for the cogeneration, what is called cogeneration.

So where you have a principal and a by-product that by-product is value, that contractual or that expectation of relationship is valued based on the additional income minus additional expenses.

• • • •

[414] Q And how does that translate to the valuation exercise here, this notion of by-product?

A Well, the primary reason newspapers are in business from an economic standpoint is to charge money to advertisers to present their message in front of readers.

The advertisers support the newspapers.

[415] Q And how does the subscription revenue fit into the economic analysis?

A Well, that is the by-product, and you can get the commitment of subscribers, or readers to pay money to be a subscriber, whether that a quarter a week, a dollar a week, $5 a week. That is a by-product of the principal function, that contractual or that relationship that is predictable is an asset of that business, and the appropriate method to apply is to measure the additional revenue minus the additional expenses that that asset brings to that business enterprise.

• • • •

[421] THE COURT: Suppose the parties have entered into [422] this agreement for the total purchase price, and on the eve of the sale or even after it's consummated, the Booth papers come to the Newhouse group and say our computer is down, we have lost our subscription list, we can no longer identify who our subscribers are, and they come to you as an impartial expert and say, we are entitled—the purchaser is entitled to a credit as a result of the seller's inability to identify the subscribers.

Is it your opinion that they would be entitled to a $60 million deduction of the purchase price? Isn't that really what you are saying?

THE WITNESS: I don't know what it would cost to correct the deficiency. In actual fact there is multiple records because you have newsboys of lists of—

THE COURT: No. Assuming that it is lost. You spoiled my hypothetical.

THE WITNESS: Sorry.

THE COURT: Not the cost of reconstructing it, possibly the cost of replacing it, which we have been discussing for a few days now.

Is it your opinion that the appropriate way to value the credit would be, as you have done it here, based upon the income approach and that the purchaser would be entitled to a credit of $60 million as against the purchase price because of the inability of the seller to deliver and [423] identify the subscribers?

THE WITNESS: It would be my opinion that the fair value is $60 million, and that the purchaser would be entitled to a credit based on the lesser of the fair market value or the cost to correct, if that were possible in some fashion.

I know that there is a court case, for example, going on in the Minneapolis about the dome where the Twins and the other sports teams play, and the dispute is whether the cost to correct—what is the damages.

The fair value has been represented as a dramatic value in the fair value because the dome has a problem. There are alternative ways of correcting it, and the damages in this situation are being measured as the least cost method of correcting it.

That doesn't mean that the value of the dome hasn't dropped.

THE COURT: No. But I take it, based upon your opinion in the case and redirect by Mr. Turkus today, that it is your expert opinion that the cost approach would not be an appropriate measure of value here and that the proper measure is income, and thus $60 million.

THE WITNESS: Yes. The proper method of income—is—is—is what is the value of that asset to the Booth newspapers? What is the additional revenue minus additional [424] expenses that that asset generates for both newspapers was $60 million.

THE COURT: All right.

MR. TURKUS: If the Court please, I would like to ask a few questions about the hypothetical.

I would like you to follow through with me, Mr. Grabowski, one at the time.

THE COURT: You may, because these are created on the spot for me, so if you want to add to it, be my guest.

MR. TURKUS: I think I have a different hypothetical.

BY MR. TURKUS:

Q I would like you to follow through with me one at a time, Mr. Grabowski, and take your time if you need to reflect on each question.

In the Court's hypothetical, the night before the transfer was to take place, the seller said, "I have lost the list of names and addresses."

A Uh-huh.

Q Let me ask you first: If in that hypothetical is what the credit would be, is what the asset that is gone, the paid or paying subscribers, or is that the subscription list, names and addresses of the subscribers?

A Just the list is gone.

[425] Q And let me move to a different hypothetical a moment.

Suppose there were the contract that the Court posited to you, and the night before the transfer the seller called the buyer and said, "We have to tell you there has been horrible news, there has been a catastrophic event, all 40,000 subscribers to the X paper died last night."

A Okay.

Q Now, what asset would they not be able to deliver in that circumstance?

A They would not be able to deliver the subscriber relationship of 40,000 existing paid subscribers paying, using—or—or—or paying subscribers using your Honor's terminology.

Q Suppose we had closer to the case, all eight papers, and you had all 460,000 odd paying subscribers who died the night before the transfer, what kind of a credit would you say the buyer would be entitled to in that circumstance?

A Well, certainly total fair market value of the subscribers.

Q Which, in your opinion, was what number?

A Was $60,407,000. I have to look at the exhibit, the table, to make sure I have the right number.

MR. TURKUS: If the Court please, I am presenting Exhibit 3 to the witness.

A As I concluded on page 11, it would be $60,407,000.

[426] Q Now, with that hypothetical question and your reflection on that, putting that—putting the other question in that context, as compared to that, if the buyer called up and said,—seller called up the buyer and said, "Last night we lost every existing copy of the lists of names and addresses of the subscribers," would you say that they would be entitled to the $60 million odd credit or something less, whatever the value is of the subscription lists?

A They would be entitled to whatever—the law as I understand in damages, they would be entitled to whatever it takes to correct that deficiency in the assets being delivered.

Q What asset would not be delivered in that circumstance?

A Just the subscription list.

Q And recalling your testimony from Monday, do you believe there is such an asset as subscription lists of paid subscription newspapers, paid circulation newspapers?

A Not the quesiton that I valued. I valued paid subscribers.

Q Is there such a list?

A Yes, there is a list. We can produce a list of names and addresses if you want.

Q. Is that the asset you valued in the case?

A No. That is not the asset I valued in this case.

• • • •

[427] Q Now, yesterday you were asked at approximately Page 355 of the transcript whether there were any free daily newspapers in the country, and as I recall, you said you didn't know of any.

During the evening recess, has any additional information come to your attention in that regards?

A Yes.

I had occasion to read an article in Press Time, one of the trade journals of the newspaper business which talks about free daily newspapers.

And there are several in the United States and I think it was 11 daily newspapers, including Aspen, which is a free daily in Colorado, and Ventura, Cailifornia, which is [428] between Los Angeles and Santa Barbara, I don't remember the others.

But they were talking about it as a way of operating a newspaper as an alternative, and there actually are some.

MR. TURKUS: At this time I would ask to have marked an exhibit which was not previously identified, because this issue has really come up in the course of this examination.

A copy was provided first thing today to Mr. Hrebiniak. I ask to have it marked as I think it's plaintiff's exhibit—I think, 9, but I will give—I think 9. We have the stickers.

We can do the marking, but I ask that it—

THE COURT: P-9 for identification.

(Plaintiff's Exhibit marked P-9 for identification.)

THE COURT: All right.

MR. TURKUS: There is an additional copy for the Court, if the Court please.

I ask to approach the witness.

THE COURT: Certainly.

THE WITNESS: Thank you, Mr. Turkus.

BY MR. TURKUS:

[429] Q I show you what is marked Plaintiff's 9 for identification purposes and I ask you, sir, if you can tell the Court what that document is.

A This is a copy of the Tuesday, February 6, 1990 Aspen Daily News.

Q And is that the free daily newspaper that you were describing earlier that was produced in Aspen?

A Yes.

From the article, I think it was published free for 11 years, and says it free in the masthead on top, volume 12, 1893 up in the right-hand corner.

MR. TURKUS: Plaintiff's move into evidence Exhibit 9 for identification.

THE COURT: Any objection.

MR. HREBINIAK: No.

• • • •

[435] Q Based on that analysis of the financial data for each of the eight newspapers, and reflecting upon your testimony [436] earlier today, are you suggesting then that the subscription revenue is really a by-product for each of the eight newspapers?

A You would make a profit based on the crude analysis I was able to do even if they just lost this revenue, and I have not reduced the expenses of the newspapers for going and getting subscribers after they lost the existing ones, going getting new ones and I know it's a big expense.

Q So it is a by-product or not?

A By-product of the principal functions of the newspapers, that is, to generate advertising revenue, to place advertisers' message in front of readers.

MR. TURKUS: No further questions.

THE COURT: I have another question.

THE WITNESS: Yes, your Honor.

THE COURT: Either on an individual basis or combining all of the Booth newspapers, did the advertising revenues prior to 1977 exceed the subscription revenues?

THE WITNESS: Yes. On the average of about 80 percent of the total revenues—total circulation revenues—total revenues and that circulation revenue is the 20 percent of subscription revenues less than what is left over.

THE COURT: So the ratio is approximately 80 percent advertising and 20 percent circulation?

[437] THE WITNESS: Correct, and paid subscribers are only a portion of the circulation.

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TESTIMONY OF DR. CHRISTINE D. URBAN

(February 6, 1990)

DIRECT EXAMINATION

* * * *

[206] Q Can you explain for the Court, if you would, the nature of the relationship, if any, for a paid circulation newspaper between the number of paid subscribers and the advertising revenues which such a newspaper can generate?

A The—let me define a term if I may.

[207] The paid circulation of a newspaper is represented by two groups. One, the subscribers that get the paper home delivered or through the mail, and another group of single copy buyers that buy the paper one at a time, either from a vending machine or coin box.

The number of paid circulation that is an important number, but not really the critical number in being able to impact advertising revenues.

The critical number is not how many papers are sold in circulation, but what percentage of the households in the market are covered by those papers.

So if you have a newspaper—there are newspapers that may be growing in circulation, but have an adverse impact on their advertising revenues because their penetration of the market, that is, the percentage of households that they cover is declining.

So the relationship between the two is based on that critical factor of market penetration.

Q Now, during the period 19—let me ask you this: Is there a relationship between the fact that a newspaper has a paid circulation and perhaps its penetration and the kind of advertising rates that the newspaper can charge its advertisers?

A Yes, there is.

Q How does that interrelate?

[208] A The paid daily newspaper in having subscribers and single copy buyers that would pay for the ad-

vertisers, give the newspaper confidence in assuring that their ads that appear in the newspaper are being read.

Therefore, the advertisers are more willing to pay a higher cost per thousand.

It's basically rate-related calculation of how much it's costing them to be able to reach thousands of these newspapers readers.

So the relationship between circulation advertising revenues is very clear in terms of the newspaper's ability not only to be able to convince advertisers that they are getting the audience that these advertisers are looking to reach, but also in being able to justify higher advertising rates.

* * * *

[211] Q Now, Dr. Urban, in your testimony you talked about free circulation newspapers and paid subscription or circulation newspapers.

Can you describe for the Court the differences, if any, between those two kinds of newspapers?

A If you look—if you were to go down the list of different characteristics of a newspaper and take a paid and a free newspaper, they would look remarkably similar.

There are significant investments made in both paid and free newspapers in providing news coverage and editorial coverage that enhances readership of the newspaper.

There are significant investments made in both paid and free newspapers in making sure that the publication is delivered on a timely and consistent basis and meets readers' expectations and customer service.

There are strategies in both paid and free [212] newspapers that deal with how to prove the quality of the audience to advertisers and be able to go out and look for advertising revenues from local stores or other merchants that would like to advertise.

So the only real difference that we can see from free versus daily, free and paid newspapers, is the fact that

paid newspapers have circulation revenue by charging their readers a subscription price or cover price.

Q Why in your experience, Dr. Urban, would a publisher of a free circulation newspaper make the kind of efforts that you are talking about in terms of editorial contents, delivery service, and in terms of things that are focused towards the readers when the readers are not paying for the product?

A Without the publishers and the owner of free paper have the same competitive forces on their audience as do paid newspapers.

You have the same kind of environmental factors, taking away readers' time and attention from reading the free paper as from reading the paid paper.

So in order to be able to create the audience and generate advertising revenues, as well as to insure that they have an audience permission to issue, it is important to invest in providing people with news and information that has some relevance to them, and is of quality enough that [213] they would be willing to spend their time reading that publication, so the goal is the same.

The goal of the paid and free newspaper is the same, to be able to provide the readers with news and information in an attractive and professional, and high quality way to get them to read the newspaper and in doing that, provide an environment for the advertisers to insure that their message would be—

THE COURT: Do advertisers view the two types of papers differently?

Would they have more confidence, assuming that both the free and the paid go to every house in a particular area, would the advertisers have more confidence in the paid subscription newspaper as opposed to the free?

THE WITNESS: The paid newspaper often does not —the paid portion does not go to every house.

THE COURT: Assuming that.

THE WITNESS: Assumption that, a lot of it depends on the quality and relationships that have been built up with those readers.

What free newspapers have to do, because they don't have the circulation revenue or the paying portion to be able to prove that that—that the readers are desiring the paper and using the paper, they do market research studies or readership studies in order to survey the people in the [214] market and find out not only how many of them are reading it, but how frequently they are reading it.

So they have to be able to prove it in some way and they often do it through market research.

The advertisers are increasingly more confident in the ability of the free newspapers to be able to attract an audience and hold onto that audience, as evidenced by the fact that many major advertisers, including large department stores and large automobile dealerships, and a variety of other very good advertising accounts are buying full page or two full pages or three full pages in free newspapers.

MR. TURKUS: Thank you, your Honor.

Q Based upon our experience, Dr. Urban, how do you respond to the government's suggestion that free circulation newspapers simply do not have the significant editorial contents found in paid circulation newspapers?

A I dispute it.

I think the only free publications that I can think of that don't have news editorial contents are Shoppers, and we are not talking about Shoppers.

We are talking about free newspapers that have significant editorial content, even to the extent in the sad experience of some of our clients before we started working with them, that readers in the market would sometimes tell us on surveys that they prefer the news coverage that they [215] are getting from the free weekly newspaper to what they are getting from the paid daily newspaper.

• • • •

[225] Q Dr. Urban, based upon your expertise, how would you respond to the government's contention that,

and I am not asking you this now based upon any evaluation connotation, but only on the contents of what they have said, they contend that, page 12 of their brief, that the Morning Ledger's valuation experts make a plainly erroneous representation that, and I quote, in this case they are quoting from valuation testimony in deposition, I believe:

A paid subscriber payment and a free distribution newspapers have the same categories of revenues and expenses with the exception of the subscriber revenue and the cost to collect that revenue.

Based upon your expertise in the newspaper industry, how does that comment hit you?

A Could you—they are saying that that is an erroneous assumption?

[226] Q Correct. Say it's plainly erroneous.

A To me, it's plainly erroneous to look at newspapers like this and assume that they do not have the cost structure in terms of the news editorial costs and cost of delivery service and cost of producing as high quality a publication as this is, and so I would contest that.

I think that it's very clear based on my experience, not only in paid daily newspapers, and my knowledge and our companies' knowledge of the cost structure of paid daily newspapers that we consult with, but also my personal knowledge of free newspapers' cost structure that they have essentially the same components of cost with the exception of the cost of collecting circulation revenue.

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[236] Q Based upon your expertise Dr. Urban, can you tell the [237] Court whether these matters you described are of material concern of the newspapers in the conduct of their business?

A They are of critical concern and material concern because the inability of the paid daily newspaper to retain paid subscribers is putting at risk, not only their circulation revenues, but the credibility they have with the advertisers, and being able to deliver the audience and the kinds of coverage that they require—that the advertisers require for their advertising message.

The examples of advertisers that have gotten newspapers to not only continue, but even improve news editorial contents simply is a way of being able to maintain this audience and environment for their ads are quite numerous over the last few years.

So it's an issue not only being addressed and worried about and worked on by the newspaper industry, but very much of interest to the advertisers and the customers as well.

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[238] Q Directing your attention to pages 23 to 25 of plaintiff's Exhibit 4, your report, Plaintiff's Exhibit 4, would you tell the Court where in that report you summarized some of the efforts that newspapers take to replace lost subscribers and to maintain market penetration?

A Yes. I do.

And summary is a good word, because if one were to list out as oppose to summarize, if one lists all things newspapers did to try to retain subscribers or be able to solicit new ones, I think it would go on for an awful longer than two typewritten pages.

What are summarized here are basically four areas that newspapers have been working in very steadily, on Page 23, the two summary statements of that, newspapers—most paid daily newspapers I am familiar with in the United [239] States, Canada and elsewhere, have been making and have continued to make increasingly aggressive and increasingly expensive investments in circulation sales.

Now, circulation sales programs come in a wide variety of shapes, sizes and colors. They include not only telephone solicitation and being able to get on the phone and talk to nonsubscribers and other people and to try to sell them a subscription to the newspaper, but also door-to-door sales and what are called boy crews, which is a

variation on the door-to-door sales of sending either the carrier or carrier's supervisor to the door to solicit.

Many newspaper started to distribute free samples of the newspaper two or three days.

In some cases, some newspapers have sampled nonsubscribing households with two or three weeks of the newspaper to get people familiar with the product to order it and subscribe to the newspaper.

There are external promotions, advertising campaigns, televison ads, premium offered, sweepstakes to participate in. Wingo Bingo, variety of different promotional techniques designed to be able to sell subscriptions to newspapers.

Now, in addition to investments made in circulation sales, that is to gain more subscribers, there are an awful lot of programs that are being used by newspapers across the [240] United States to retain current subscribers. A lot of the programs concentrate in one of two areas.

One area being circulation service, which is taken from market research surveys or from complaints, people write in or call in about the service, the critical expectations that people have and trying to fix those.

For instance, one of the—one of the things that often happens with a newspaper and its home delivery service, is that, for instance, if you are on Johnny Jones' route and Johnny Jones, who is your carrier, and has been your carrier for a year or two, always put your newspaper inside the screen door to keep it from getting wet and keep the dogs from chewing on it and a variety of other things, Johnny Jones passes his route over to Billy, and Billy, who doesn't even know that you used to get your newspaper from Johhny put nicely between the screendoor and your front door, does what all carriers would consider to be good service, which is, to put your paper on your front stoop, right in front of the door.

It is sad to say, but a lot of people will call the newspaper and complain that they are no longer getting their

newspaper between the screen door and the door because that became their expectation of good service.

Even though industry standards would argue if the newspaper is in front of your door, as opposed to in the [241] bushes or three doors down, you have good service.

So all of these customer service programs and subscriber attention programs are very dependent on knowing what the subscriber's expectations are, not just an abstract principle of what a newspaper would consider to be good service.

The retention programs on home delivery, and when the paper gets there, and how the paper is delivered, and whether or not the paper is in a plastic bag or not, all of those factors in their absence could be the cause of a dropped subscription.

So newspapers are very much aware of or want to be aware of what people want and meet those expectations.

The other side of retention programs has to do with news editorial contents and making sure that the surveys include measures of not only what people are reading in the newspapers, which is a traditional kind of product measure, but we have been asked for years to ask on surveys, what do people want to read in the newspapers, so that more contents could be added and more information and news could be put into the newspaper to give it a better chance of being retained by its present readers.

So those two factors are clearly investments that are being made and have been made for years in the industry.

Other investments that are being made in trying to [242] overcome the problem of declining penetration are, I am happy to say, increasing numbers of newspapers hiring market research to be done, not only on their readers, but also on nonreaders, to ask what would it take to be able to get you to subscribe to the newspaper, and to trap the success of all of the retention and sales programs that I just described in something other than just an ad hoc way.

In other words, the investments in the newspaper industry in sales programs and retention programs have gotten to such a monetary amount, that it's worth it now to pay to track the results of the program.

In other words, the dollars at risk in these strategies to be able to grow circulation and grow subscriptions have reached a significant enough level that it's worth the incremental cost to track to see how successful it could be, and if it is not as successful as you like, to have consultants such as Urban & Associates come in and make it more successful because we are really working at that kind of level of improvement necessary.

Q The efforts that you mentioned that related to improving delivery service and changing the contents or qualities of the product, newspaper that they actually delivered to their subscribers, are those expenditures related only to retaining existing subscribers or are those expenditures very much part of the effort to obtain new subscribers or [243] replace lost subscribers?

A It's very difficult to divide them and say, this hundred thousand dollars went for objective A, and this hundred thousand dollars went for objective B.

The kinds of programs, both sales and retention programs are dependents on so many factors. They are dependent on the news editorial quality, the service quality, the home delivery service quality, the responsiveness of a newspaper to something as simple as answering the phone when people call.

I don't know of a way to be able to take those dollars and say, this should belong to that objective and this should belong to the other.

Q How widespread are the efforts you described to the Court throughout the industry?

A They are widespread.

Every newspaper that I can think of in the United States has some degree of program in both retaining as well as in trying to attract new subscribers, from the very smallest to the very largest.

Q Tell us, based on your personal knowledge, whether these kinds of efforts were engaged in by the Booth newspapers?

A From what I read of the Booth Newsaper's history and my knowledge of the market, yes. They were engaged in Booth markets.

[244] Q Are the matters you described thus far in your testimony here today and the views that you stressed, simply opinions that you form in connection with your testimony here, or are these views widely accepted throughout the newspaper community at large?

A I would say that all of the views I expressed are widely accepted. It would be difficult to find somebody knowledgeable in the industry that would argue with any of the points.

Q Could you describe for the Court, the relationship between total paid circulation, paid subscribers and single copy sales for a paid circulation newspaper?

A The total circulation—total paid circulation of a daily newspaper is made up of two groups.

The home delivery—home delivered subscribers or those that get subscriptions through the mail, commonly referred to as subscribers, as well as the second group of single copy buyers and single copy buyers could be buying it from a stand, newsstand, rack, coin box, a boy standing at the intersection before the toll gate selling a newspaper by him.

In most cases, a daily newspaper would have significantly more subscribers than single copy buyers with the common ratio being '80 to '85 percent of its total paid circulation represented by subscribers and then, of course, [245] the 15 or 20 percent represented by single copy buyers.

The importance of both of these two groups is different and yet complimentary.

The subscribers have—as a matter of measurement by the Audit Bureau of Circulation, the subscribers have value, as do the single copy buyers, but the difference is

single copy buyers are, in most cases, not buying the paper seven days out of seven, but buying it on whatever day they feel they would like to read the newspaper.

So, therefore, a single copy buyer can't be counted on to the same extent as a subscriber to be in the audience either for that day's column, if I am a columnist or if I am an advertiser, to have the same kind of probability of seeing that ad.

So the two components don't make up paid circulation, but the subscribers and single copy buyers have complimentary functions when you look at how people come in or leave the market of a newspaper.

Very often, whether you move into town or whether you decide to switch newspapers, whatever the case may be, an individual will often buy single copies of the newspaper long before they sign up for a subscription to give it a try, to do a trial of whether or not its meeting their information needs and advertising information needs.

Single copy buyers then often are entry level [246] subscribers, and its extremely important to keep single copy availability high and make sure that the quality of those copies and the care taken with being able to sell them is just as high with subscribers because many people are deciding whether or not they should subscribe to the newspaper.

Likewise single copy sales are important because of the concept I referred to before as churn, and these are individuals who subscribe to the paper but because of dissatisfaction often with service, they said, look, I don't want to be a subscriber any more, I quit subscribing, but they quit the delivery but still buy it once or two times a week, and they become single copy buyers again, as a critical component of the audience, but not as tied or as loyal to the newspaper as would be—as they would have been when they were subscribers.

And the critical thing to think about, although it's a concept unfortunately not measured by the Audit Bureau of Circulation is frequency of readership.

One of the things that subscribers—that adds to a subscriber's value is the fact that they have a higher availability and higher chance of reading the newspaper every day.

And a single copy buyer, you have to sell them the newspaper every day, and they can just as easily decide not [247] to put their 35 cents in the box as they can put their 35 cents in the box, so there is just one more obstacle being put up to a newspaper attracting them into the audience than there would be with the subscriber.

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[249] Q Based upon that experience, Dr. Urban, do you have any opinion as to whether the subscribers in the Booth newspapers as of May 31, 1977 were likely to subscribe indefinitely to the papers or whether the subscribers were likely to have a limited duration?

A Those subscribers would have a limited duration and I would say would not subscribe indefinitely.

Q Now, what factors would lead you to conclude that the paid subscribers to the Booth newspapers as of that particular date were likely to have only a limited life during which they could be expected to continue as subscribers to those newspapers?

A A variety of factors.

First of all, the trends that we looked at in terms of historical attrition and churn were the Booth [250] subscribers.

The second is the fact that within the Booth markets, I saw no dearth of the environmental problems or demographic or lifestyle changes or competitive changes that I described earlier, as being the causes of this kind of decline.

So you can see the evidence of it in declining market penetration, and you can look for the factors that would cause it, and that is clear analysis, that Booth markets were neither immune from any of the factors, nor did any of their historical penetration changes belie the fact

that they are also—their newspapers also have subscribers that will drop off.

Part of this is indeed just common sense, people do die. People do get sick. People do move away.

Some of the Booth markets had economic downturns in terms of the automotive industry or high unemployment that in some cases the market shrunk because people moved away. They moved out to find jobs somewhere else.

But in addiction to those kinds of overall factors, there is also clear evidence that these newspapers were suffering from the same kind of external problems others do.

Q Based upon your expertise, Doctor, can you tell the Court approximately how many new subscriptions a newspaper must satisfy in a given year to maintain its subscriber [251] levels?

A That number of course varies by market and the size of the newspapers.

But my experience is, most of my clients and most newspapers would be doing solicitation and circulation sales programs to be able to write half their list.

In other words, if they have 100 subscribers, they would be writing 50 orders every year in order to just maintain that level of circulation.

In other words, let me explain it the other way.

In other words, to end up with one paid subscriber at the end of the year, a typical number would be that you have to write 10 or 15 or sometimes 20 orders to be able to bring those people into the subscriber pool, and then 19 of those 20 will drop off, leaving you one actual increase.

So that although the number varies, the proportion seems to be about the same approximately in newspapers across the United States.

THE COURT: I am not sure I understand that.

You mean there is a 50 percent attrition rate in paid subscribers?

THE WITNESS: Let me describe it in terms of process, because I think it's easier to understand.

Let's say you have a newspaper that has 100 subscribers right now, and you know that just because of [252] natural factors people die, move away or the fact that they have become dissatisfied, that of those 100 subscribers, it's not unreasonable that 10 or 15 or 20 of them will not be there by the end of the year.

In order to stay at that same circulation level, not even increase it, but to stay at that level, you have to crank up the phone solicitation and direct mail solicitation and all of the rest of it, probably to go out and write at least 40 or 60 or, sometimes, 80 orders in order to end up with people that will keep that circulation at the same level.

Running faster and harder each time you do it, because there is a certain degree of wear-out factor by the time that you had the sixth phone call from the solicitor.

THE COURT: If you made no efforts to replace customers lost, what do the statistics show as to the probable attrition rate in a year?

THE WITNESS: If you make no efforts to replace those people, then not only would those people be gone, but you probably would be losing at a faster rate as time went on, because a lot of this is just keeping the news editorial and service levels high and keeping sales levels high as well, so they would drop off, I would hesitate to say, like flies, but quite quickly in terms of paid subscriber declines.

[253] BY MR. TURKUS:

Q Let me ask you this:

In response to a question from the Court, you said, you posited a paper with a subscriber base of 100 subscribers, and you said maybe 10 or 15 would fall off in the year, and in order to stay even, they would have to sell 40 or maybe 60 or even more subscriptions.

Assume we are talking 40. What happens to the 25?

I mean if you sell 40, why do you only pick up 10 or 15 that you lost, what happens to the rest of them?

A A lot of things.

Let's say that—let's accept for sake of this hypothetical that you wrote 40 orders. In other words, you call people and 40 said, "Send me a subscription."

Of those 40 people, what—many of them may have been doing is not at all ordering the newspaper, but they may have been actually ordering the gift you were going to give them with the subscription.

Just like magazine sales, where if you sign up and prepay for a year's worth of a magazine, they will send you a clock or send you a stuffed dog or some kind of gifts.

An awful lot of people that are responding to that television ad or phone call or that direct mail campaign [254] basically want the clock or the stuffed dog or the gift, so a lot of them drop off because once they have gotten the premium, they are satisfied.

Some of them drop off because what they had was just a really good salesman who talked them into something that then when they got it, they really didn't want it.

Some people will drop off, because when the paper does come, they are still not satisfied with quality of the news coverage or coverage that they are receiving of their community or its advertising contents, or its delivery service, so they will quit because their expectations have not been met in terms of what they were told to anticipate.

And so what you see is of the 40 orders that you wrote, you have people that churn out, people that drop off and people that never wanted it in the first place, built into those 40 orders.

So what you are left with then is the one or two or five subscribers that you did indeed meet their expectations after you solicited and sold them a newspaper, and they then come in to replace the ones who had dropped off.

Unfortunately, a lot of the experience of newspapers is that you can't write the orders fast enough to be able to replace the people that drop off because these factors feed on each other and the churn and attrition rates become very difficult to replace as they start falling out [255] the bottom of the sieve.

Q You may have answered this question in response to the question from the Court a moment ago, but in case there is more here, let me ask:

Earlier in your testimony and in your report you described a variety of efforts that newspapers make to replace the subscribers that they lost on to maintain their markets penetrations.

Based on your experience what, if anything, would happen to a newspaper which failed to make those efforts?

A If you fail to make those efforts, your subscriber list would continue to decline and the subscribers would continue to drop off.

Your prospects for remaining a successful paid daily newspaper would be dim, because as that process would continue to happen, the increasing weakness of your newspaper's subscribers and your newspaper's paid circulation would quickly become evident to your advertisers, who would look not only at the circulation figures and penetration figures that are published from the Audit Bureau of Circulation, but would look around the neighborhood and see that fewer homes have the newspaper in front of their driveway or stoop.

So you would be putting—by letting this problem go and not dealing with it or not wanting to deal or trying [256] to sell subscriptions or retain subscribers, the subscriber list would continue to decline year after year, and you would be putting at risk the circulation revenues and also advertising revenues of the newspaper.

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Q If we look at the total number of subscribers, and you say for—say for Booth newspapers in 1977, they had approximately 460,000 subscribers, and maybe today they have the same number or even more, looking at those figures and based upon your expertise and your experience, would you say that that is a process that happens all by itself, of how would you response to respond to the notion that is what the Government is suggesting?

A The thought or concept that subscribers come to the newspaper all by themselves or that those numbers are evident from an automatic process is ludicrous based on my experience in the industry.

Prudent and reasonable newspaper operations have been spending increasing amounts of money trying to sell [257] subscriptions and retain subscriptions, on very much of an expectation that this is not an automatic process, and that it's difficult and becoming increasingly difficult to bring in those subscribers and maintain them once they are there.

I don't think subscribers automatically replace each other, nor do I think that there is an absent group of people out there waiting in line for newspapers.

It's a very difficult process of selling and meeting expectations and satisfying the customers that we have.

Q Now, also earlier in your testimony and in your report you described circulation sales programs.

Based upon your expertise, how do those kinds of programs, or how do the subscribers which are attracted through those kinds of programs where, say, a newspaper hires an outside sales force as opposed to using their paperboy, when they hire an outside sales force for a circulation sales program, how do the subscribers they get through that program compare to the regular, shall we say, seasoned subscribers which the newspapers have before they conduct that campaign?

A The evidence we have from markets where we have done and studied this issue quite intensively, suggests that the subscribers that are gained from hiring an outside sales force or outside boilerroom operations to kind of come in [258] and do the solicitation don't stay as long, first of all, in the newspaper.

They are much less likely to be resold, if you will, or come back to the newspaper as a single copy buyer, because in many cases you are dealing with those subscribers being brought in because of the premium or salesmanship or offering or free or the discounted kind of prices

that were offered to them on the phone or in the mail, so those subscribers don't stay that long. They don't have the same degree of readership in the newspaper.

When we ask on surveys, how much of the newspaper did you read, 100 percent, 75 or 50 percent, the subscribers to a newspaper tend to have a higher depth of readership, be reading more in that newspaper than do the people who were brought in, especially brand new subscribers who came in right after a very intensive or sales program who may only be reading Ann Landers or the comics and not gaining value from a newspaper. They are much more likely to drop out quickly and find it difficult to be resold.

In fact, the experience in the industry is that outside sales companies that come in and set up a phone room and go through the list, they may sell an awful lot of subscriptions, but there is also a higher probability that those new subscribers won't stay or they won't pay.

So what happens is that, they tell you on the [259] phone, yes, indeed, I will be happy to subscribe to the newspaper, but then after the newspaper comes, they don't pay.

* * * *

[261] Q Let me ask you one another question. This relates to a hypothetical that was presented to one of the other witnesses yesterday by the Government's attorney, and let me try to describe the hypothetical to you.

Mr. Grabowski was asked by Mr. Hrebiniak to suppose that on day one, and I maybe paraphrasing, but I will get as close as I can.

On day one all of the Booth newspapers were sold to a new publisher without any paid subscribers, and then on day two, you went out and solicited every household in all of the eight market areas, and you had to pay this sales force say $4.50 a piece, which for purposes of his question was the cost of such solicitations by outside sales forces, you would have to pay $4.50 a piece for each household they solicited.

And he suggested in his hypothetical that by doing that on day two, or I guess it was day three, not quite sure, you would have exactly the same 460 odd thousand subscribers that you had on day one or zero before you received the papers from the subscribers.

How do you react to the suggestion of that kind of scenario—

A Well—

Q —based upon your expertise?

A Well, first of all, based on my expertise, it's a very [262] strange hypothetical that anybody would buy a newspaper without the paid subscribers that go with it.

So that that is a difficult prospect for me to imagine, that you would sell a newspaper but say, no, we are not going to sell you the paid subscribers.

Q Have you ever seen somebody buy a paid circulation newspaper without paid subscribers?

A I have not seen anyone do that, no.

Q Ever heard of anything like that?

A No. Not to my recollection, no.

The—but given that improbable circumstance for a moment that a seller and buyer could agree on such terms, on the—on day two, at dawn of day two, when you went out and solicited, you put together the most massive phone room I can imagine to go out and call every household in the market, the probability that you would be able to reach all of the households and get the subscribers who were there on day one to say, oh, yes, don't worry, I will come back, that is a much lower probability after you severed the relationship and ceased providing them with the newspaper and service and meeting their expectations during that moment in time, than there would have been if you had not done it, of course.

The other concept that is difficult for me to understand is not only why one would want to do it, but how [263] long would it take to call every household in a market and be able to not only call into the household, but, A, reach somebody who is at home.

B, make the kind of sales effort or re-subscription effort and pitch that you would describe.

My guess is that it would take months to be able to do this, during which time you would be spending, in my experience, a lot more than four or $5, if that was the number you mentioned in the hypothetical. You would be spending a lot more than four or $5 per household to even make the contact.

You would also be without the circulation revenue that the subscribers would have been providing during that time period necessary to recontact them all.

And then the probability that all of them would come back is, to me, an impossible expectation. Some of them would not come back.

Q How can you say that?

Do you have any experience in measuring the ability to go out and get people to come back after there has been a termination of service?

A Absolutely.

A lot of the work that I was describing earlier under the headline of retention programs, has to do with calling former subscribers who cancelled or, for some [264] reason, you didn't deliver. There is also a—fault, sometimes that happens in the newspaper, not maintaining the qualities of service it should.

In calling former subscribers saying, "Would you please come back." So I have data and personal experience with looking at—in a lot of markets where former subscribers of very recent cancellations saying, "No, I won't come back. I didn't like the paper. I don't like the carrier. Never brought it on time. You let me alone for a week and then send me two bills," you know.

There are 100 variations, but in my exerience, you can call former subscribers who quit as recently as about a week ago or month ago, and they will not come back.

THE COURT: Is valuation part of your expertise, Doctor?

THE WITNESS: No, we don't do valuation.

THE COURT: Let me ask you this anyway and if it is not within your area, please do not hesitate to tell me that.

If somebody was sitting down to buy a newspaper that had paid subscribers, and the buyer and the seller were discussing what amounts should be attributable to that fact, the dealer would say it generates X number of dollars and the value is so much. In this case, there has been evidence of $60 million.

[265] And the buyer says, well, that is crazy, because if you didn't have these paid subscribers and I bought the newspaper, I would hire people and spend three or $4 million and be in the same position that you are in today. Why should I spend $60 million to buy what you have in the value of paid subscribers where I could go out and spend $4 million and be in the same position?

THE WITNESS: Uh-huh.

THE COURT: Is there merit one way or the other in that discussion?

THE WITNESS: If I were listening to that conversation, I would say to be able to go out and recreate the revenue generation power of the subscribers for three or $4 million would be a hell of a deal. I don't know how to do it for three or $4 million.

There is a lot more built into these subscribers' ability to benefit the newspaper business as a business than just their existence and they are not as easy to get back as some would believe.

There are long-standing relationships and meeting of expectations that go into what makes these subscribers beneficial to the newpaper and to the advertisers that provide the revenue and as well as the readers do.

I don't see that the numbers that would have been tossed around in the hypothetical situation make a lot of [266] sense to me.

THE COURT: All right.

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CROSS EXAMINATION

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[271] Q Now, you would agree, wouldn't you, that subscribers are at-will customers?

A I don't know what—tell me what an "at-will customer" is. I don't understand.

Q There is nothing legally binding them, is that it?

A I am still not—I don't know what "nothing binding them" means.

Q Well, Dr. Urban, because a subscriber is here today, doesn't necessarily mean they will be here tomorrow, does it?

A True. Because you have a subscriber today. They have—they can stay tomorrow, or they have the evidence of sometimes dropping off tomorrow.

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[294] Q This is the hypothetical where they don't have the subscription list, don't buy it, they lost it, what-have-you, and they try and contact the subscribers anew and call everybody in the area and you said some wouldn't come back.

Isn't it correct you said some wouldn't come back because the paper has failed to meet their expectations in some way?

A That is part of the reason some may not come back, but let me clarify.

Q Sure.

A In reasking the hypothetical, you used the term "subscription list," and we are not talking about the list.

I am talking about human beings that behave a certain way towards the newspapers, and if what you have are subscribers, a hundred human beings that on Friday expected to have the newspaper delivered, because they were subscribers to the paper, and then during the hypothetical sale to the seller, who didn't want to buy a paper without their subscribers, which is what doesn't make sense to me, if during the sale, the paper didn't come,

yes, you have [295] violated 100 human beings' expectations of what it was that newspaper represented.

The time period that I was referring to is the fact that you can't pick up the phone a day or two later and suddenly and instantly reask the whole market and magically have these subscribers come back because those subscribers have violated—you violated their expectations, you have damaged in some cases the relationship, you know, that they had of trust that the paper was going to get there 6:30 on their doorstep.

It's just also physically impossible to be able to regenerate that without building in enough time to make the phone calls, talk to the people.

So what is—I hope that is responsive to what you were asking.

Q I think it is. Let me sum up.

You are saying when you try and do it again the problem with the defeated expectation and disruption in the relationship between the paper and subscriber, is that what you are saying?

A No. I am saying an important part of why a lot of the subscribers you may have had on Friday of day one, when you do finally get to call them at great expense and finding them and contacting them, may not come back to the newspaper.

[296] Part of the reason is because of those violated expectations of service, part of the reason is because they may have found another competitor in their eyes equally good at providing them news or information or advertising information and, therefore, they have moved their subcription or moved their time or moved their attention or moved their behavior over to some other form when you were not there.

And the process of doing that would be so tremendously expensive to be able to get even back that portion of subscribers, that it would be an imprudent suggestion to imagine one would ever try to do that.

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[306] Q By "category," you mean the same types of expenses, right?

Now, I am the one confused of definition.

By "category," you mean they have sales staff, production staffs, printing process?

A Both have news rooms, staff writers. Both have graphic artists.

They both have categories of costs that are related in all of the departments of the business, save one, which is that the free paper does not have a category called circulation revenue, managers or collectors, or solicitors or billing office for circulation.

THE COURT: Let me see if I can help.

Assuming, if you can, that you had two newspapers serving the total community with identical circulation, one paid subscription and one free, is there any way that you could render an opinion as to whether the cost of one would be greater than the other?

THE WITNESS: If you—in the situation of an identical market with two identical circulations, my [307] estimate in this hypothetical, my estimate would be that if they both were striving to be read by readers, they probably would have very similar expenses, magnitude of dollars, very similar expenses for reporters, photographers, all of the people involved in creating the news editorial contents.

The cost of production are essentially the same, costs of advertising sales would be essentially the same, because they would be going after and competing for the same advertising people.

They still have to make—the free paper still has to maintain the quality and efficacy of its home delivery and distribution systems, so their costs would be essentially the same there. They wouldn't have the cost of going and asking people for money.

So given the same size operation, you are dealing with very comparable costs and magnitude as well as in structure of those various departments of the newspaper, be-

cause both of those two entities would be looking for the same thing.

They would be both looking to convince you as a resident of that community to read them and both trying to convince the same set of advertisers to pay them to be the vehicle of messengers that were designed to reach you.

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TESTIMONY OF LARRY D. BERKEY

(February 7, 1990)

DIRECT EXAMINATION

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[444] Q And what, in particular, was the question or questions which were put to you or DeLoittle & Touche Valuation Engineering Associates in connection with the matter?

A What was the fair market value of the subscribers of the Booth newspapers as of May 31, 1977?

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[448] Q Based upon your expertise, what conclusion did you and DeLoittle & Touche Valuation Engineering Associates reach with regard to the fair market value as of May 31, 1977 of the paid subscribers of the Booth newspapers?

A We concluded that the fair market value of the paid subscribers of the Booth newspapers as of May 31st, 1977 was $67,773,000.

• • • •

A As I stated earlier, we tried to place ourselves in the shoes of a buyer and seller, and determine what fair market value a property would exchange hands at.

It's generally-accepted valuation theory applied both in my experience in the valuation industry, as well as prior corporate jobs, that that value is determined by the net present value of expected future economic benefit, and [449] that is what the income approach does measure, and that is why I am of the opinion it is the appropriate measure to determine fair market value of the asset here.

Q What revenues and what costs did you attribute to the paid subscribers of the Booth newspapers as of May 31, 1977 in your valuation methodology?

A In looking at what revenues and what costs to include, we tried to look strictly at those revenues and

costs that are attributable or in addition to the assets' existence.

Specifically, we looked at free distribution newspapers and what costs they incurred and then paid subscriber newspapers, since that is the asset in question, that is in addition to a free distribution in the case of the paid subscriber newspapers, the only class of costs and revenues and costs which are, in addition, are the subscription revenues and the cost associated with collecting those subscription revenues.

Those are the additional costs, and the only additional costs and revenues and the only ones I have considered.

Q Why in utilizing that method did you not net out or subtract the costs—production costs of producing the newspaper and other similar costs?

A As I indicated earlier, there are newspapers, free distribution newspapers, in which all of those costs are [450] incurred.

They are incurred in the process of that newspaper doing its business, which is namely getting its economic business—I should say, there is another business, but there is an economic business of delivering the advertising revenue to readers.

And all of those other costs of production, delivery, are in those newspapers. Therefore, in a paid subscriber newspaper, the only additional costs and expenses are those I referred to earlier.

Q How, if at all, Mr. Berkey, would your conclusions change if you determined to allocate to this particular asset, certain additional expenses such as the production costs of producing the newspaper?

A I understand there has been a lot of discussion revolving around all the location of production costs and overhead, and while we are of the opinion that the method we used in our report is the best method, there is an alternative method, which is used in the valuation industry, in which revenues and costs are allocated, and we performed an analysis using that method, and we found

that the results of that analysis did support our conclusion as contained in this report, and if your Honor would like, I can get into some of the details surrounding that analysis.

THE COURT: Well, that is up to counsel.

[451] Q Could you summarize, Mr. Berkey, what that analysis was and what it showed?

A In that particular analysis in which we are doing an allocation, we start with an allocation of the revenues, again through discussions with industry experts and people in the industry, it is stated and all of the experts would probably agree in that area, that there are additional advertising revenues which are attributable to the existence of paid subscribers.

In the first step, we allocated revenues.

Secondly, we took all expenses, productions costs, delivery costs, overhead costs as well as a fair return on other assets and allocated those costs to those revenues to arrive at a conclusion of fair market value.

Q And did you come to a conclusion as to what that approach would or that method would—what value you would derive for the fair market value of the subscribers for Booth newspapers as of May 31, '77 using that method?

A Yes. Using that method and also perhaps had somewhat limited information.

We don't delve deeply into cost structure, therefore we allocated all costs.

I draw the differentation that there are substantial costs associated with acquiring new subscribers that we feel are not allocable to the existing subscribers. [452] We were not able to hold those expenses out, so we left them there.

In doing that and allocating all costs, including those costs, we concluded a value using that approach of approximately 61.5 million.

* * * *

Q Now, going back to kind of the bigger picture and I am trying to get through it quickly and not be too repetitious of previous witnesses, but why did you conclude that the income approach was the correct approach to use in valuing this asset as opposed to the other alternative basic approaches to valuation?

A Okay.

As I am sure has been covered before, and there are the three basic approaches of cost, market and income, and in looking at the alternatives, we concluded either that there were just not the information available or that it was impossible to identify those costs associated in this asset, and therefore a limited—eliminated those and, secondly, or I would point out that in an income producing asset, [453] which we are valuing here, buyers and sellers will look at the expected net future benefit as being the fair market value.

So, both from the point of view of the data for the other approaches either not being available or probably impossible to pull out, it has the advantage of truthfully measuring the economic benefit to the seller should he continue to hold it, and he wouldn't be willing to give it up for less and, likewise, the buyer being willing to pay for that expected future economic benefit.

Q Now, why, Mr. Berkey, in your expert opinion, is it appropriate to value an asset based on the income approach when the asset produces that income only as part of this ongoing enterprise?

A Again, we are looking at an ongoing business enterprise here, and we are trying to establish that fair market value at which an asset that is a part of that ongoing business enterprise would change hands.

So we look at that asset as it functions in the business enterprise and look at its contribution to that enterprise.

What additional contribution does it bring to the enterprise that fairly measures the fair market value of the assets in the ongoing business.

Q Are the evaluation principles that you have just [454] described really throughout your testimony thus fa[illegible]day, principles or theories or methodologies that you uniquely applied in this valuation exercise, or are they generally-accepted principles within the community of valuation experts?

A The principles are generally accepted principles in the valuation community and the specific method used in this instance is also generally accepted in the valuation community.

Q Can you explain for the Court whether based upon your expertise, you reached any conclusion as to whether the paid subscribers of the Booth newspapers were assets separate and apart from the goodwill of those newspapers?

A Yes. As a valuation expert, did reach a conclusion.

Q And what was the conclusion?

A That they were, indeed, separate and apart from goodwill.

Again, looking at it as a valuation expert, since I am not a legal expert and part is a question of law, and from a valuation point of view, we look at it and say, can I separate out the asset and I separately identified the asset.

Can I establish a value for that asset and additional income stream, net income stream attributable to the asset, as well as, does that asset have a reasonable [455] determinable life?

We have dealt with the issue of we are of the opinion that these subscribers are identifiable. I don't know if that is—but they being valued.

We have identified the additional net income stream available to that asset, and SRI has prepared a report in which they have independently established the reasonable determinable life as modified by the stipulations.

We have met those tests, which as a valuation test is—we apply to say is the asset separate and apart from goodwill.

THE COURT: Going back to your opinion as to the value, is that opinion in any way conditioned upon the fact that this asset is part of an ongoing operation?

THE WITNESS: We have measured its value as part of an ongoing operation, yes.

If it is sold in what I would call in liquidation, it's not unlike the printing press.

If the printing press is sold separate from the business, so to speak, sitting in the middle of a street, it has a value which is distinctly different from part of the going enterprise, where it is proper to include and has been included in prior judicial decisions, where the installation turnkey value, things such as that, are included as part of the value and use, as opposed to value being sold separate [456] from the business.

Likewise, for the paid subscribers, they do have a value as part of a going concern which is different from being sold separate from the business.

* * * *

[458] Q What, Mr. Berkey, in your expertise, is the appropriate method of determining of the value of the goodwill of an enterprise such as the Booth newspapers?

A In that it would be the residual method from the business enterprise, and in that you would have the value of the entire business enterprise and deduct the value of all of the other identified assets, such as, working capital, tangible assets and other identified intangible assets, and the goodwill would be the residual.

Q Why, based upon your experts and expertise, is that the correct method for valuing the goodwill of such an enterprise?

A It is the generally-accepted valuation methodology. It is currently dictated by treasury regulations and I also believe it to be the IRS's position in terms of the correct method to value goodwill.

Q How do you come to know that that is the correct or the IRS's view of the correct method?

A I can base it upon an actual experience in which—

MR. HREBINIAK: We will stipulate the residual method is the proper method.

THE COURT: So stipulated.

* * * *

[459] Q Based upon your expertise, Mr. Berkey, how would you respond to the Government's contention that the paid subscribers of the Booth newspaper are not the appropriate asset to be valued, but that if any asset should be valued, it should be the subscription lists of the papers?

A Similar to our discussion a little bit ago, to me, as I understand what subscription list is in this scenario, it is that asset totally separate and not in any way associated with ongoing business.

It's a liquidation value similar to the press being separated from the business, and none of the value attributed to its part of being part of a going concern.

Therefore, we should not be valuing the subscription. It's under the wrong premise of value. It's a premise of liquidation other than a premise of going concern.

Therefore, subscription list is, as I understand it to be used in that term, is not the proper asset.

THE COURT: Of course, if you were buying the opportunity to make delivery to the current subscribers, you, as a matter of fact, would have to have the list. The list would have to be part of the purchase, would it not?

THE WITNESS: It would, yes, normally be part of that—the list would be and I will call it a subset perhaps, the value of the paid subscribers.

[460] THE COURT: It is a means by which you would identify the paid subscribers?

THE WITNESS: Correct.

Q Based upon your expertise, how would you respond to the Government's contention that the—I use the term advisedly—the real assets of value in this case is what is called the customer structure or the subscriber or sub-

scription structure of the Booth newspapers, and that that asset essentially lasts forever, or sometimes what is called a self-regenerating asset?

A I guess I am somewhat of the opinion that not much lasts forever, and in terms of a customer structure, again, I can point to my prior experience, which I mentioned Scott Paper, Heublein, H-e-u-b-l-e-i-n—I hope I don't offend them, but something like that, I may have misspelled it—in which the consumer products company quite often is involved in strategy, will look at a particular brand and decide to call and remove the support and almost inevitably is that the brand declines, volume declines.

In that particular instance it doesn't regenerate itself.

I think we are in a very similar situation here, that unless the newspaper spends money on that asset, and involves themselves in that asset, it also would decline, it would be a wasting asset, and it is not self-regenerating.

[461] Q In your valuation exercise, were you valuating a customer structure or the specific subscribers as of a specific date in time?

A It was the specific subscribers as of May 31st, 1977.

Q If one were to carry your analysis to its logical conclusion, would that mean that the customer structure of all businesses would be depreciable?

A No.

As a matter of fact, I think earlier I talked about how in this particular instance there are some that we have not stated are deductible when I talk about consumer product companies, where we cannot identify the customers necessarily, can't value them, because we don't know their buying habits or anything like that, we would not say that those are amortizable.

But more specifically here, there are single copy customers where we have not been able to get their behavior, know-how, either in terms of living or how they spend money. They might be just as loyal.

I am sure there are others who buy it every day religiously. But for the specific single copy sales readers and also the advertising customers, who are really customers of the paper, we have not said, if we want to use that term, that part of the customer structure is amortizable.

So in a general sense, no, and specifically here, [462] no. We are not saying that all parts of the customer structure are amortizable, only those which we can separately establish a value, and there can be established a reasonable determination life.

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TESTIMONY OF WERNER VEIT

(February 7, 1990)

DIRECT EXAMINATION

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[477] Q How would you describe the business of the Booth newspapers, Mr. Veit?

A Well, I would say that our business is to produce a product that offers news and advertising information to readers and the means for advertisers to get the attention of those readers.

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[489] Q What, if any, relationship exists between the fact that a newspaper is a paid circulation newspaper and the existing rates that the newspaper can charge?

A Well, we generally think we can charge more for paid circulation, if we have paid subscribers, because not only can we prove that—that the reader actually wanted the newspaper, but perhaps just as important, who those people are.

The advertiser tends to be very much interested not just in raw numbers, but where do these people live.

In fact, much of the interest of advertisers today is not so much in community but in zip codes. They really don't want to know how many subscribers do you have in town X.

What they really want to know is, what do you have in zip codes 49506.

The reason for that is that the marketing information that retail stores tend to have, has been collected by zip codes. I think that is short-sighted, but [490] that is what happened.

So it's only because we are able to track paid subscribers that were able to show what our—I should say what our penetration is in a given zip code as well as a given community.

So—it helps us sell advertising and it—it—advertisers are willing to pay some kind of premium. Hard to tell what it is for paid circulation versus free.

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Q What is the significance of single copy sales to a newspaper with a paid circulation base?

A Still income, and we like having it.

Q How does that differ from paid subscribers?

A Paid subscriber is predictable. We can—the cash flow is—is—is predictable. We know what will come in. [491] For reasons that I am not sure I understand, most of our customers are very good about paying their bills, so, you know, we know exactly the money coming in and we don't know what is coming in from the single copy sales.

So from a cash flow point of view—in fact—in fact, we are even willing to charge less for having the paper delivered to the house than we are on the street corner, because of that predictability and because of that value.

If you want to get the paper delivered to your house seven days a week, you get a substantial discount over buying it on on the street corner, even though we have the expense of getting it to you.

Q In average terms what percentage of the total circulation of Booth newspapers is comprised of its paid subscribers?

A Today?

Q Yes.

A About 80 percent.

Q And what was the comparable percentages in May of 1977?

A About 85 percent.

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[497] Q Have you at any time undertaken to determine the total costs involved in—which Booth has incurred really in trying to replace subscribers who leave?

A No.

Not in those terms because so much of what we do and all is wrapped up with trying to be an important, necessary institution for new people as well as ones we already have.

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TESTIMONY OF DONALD E. NEWHOUSE

(February 7, 1990)

DIRECT EXAMINATION

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[517] Q Now, was the fact that the Booth newspaper group had paid subscribers at all a factor in your determination of whether to purchase the stock?

A It was definitely a factor when we made our study of Booth, we reviewed the published information about its circulation.

We also talked to the then CEO of Booth about its circulation and made a determination that it had a substantial number of paid subscribers, and that became an important element in our thinking about Booth and did affect our evaluation of Booth.

Q So the existing—am I correct that the existence of paid subscribers and the number of them played a factor in your decision to acquire the company?

A It did.

Q And were those two factors also part of your decision in [518] determining what price to pay for the stock?

A Excuse me.

Did you say "two factors"?

Q Yes. The existence of paid subscribers and the number of them.

A Yes.

It had—it did have a—it was a factor in a decision as to what price to pay.

Q Now, did you at that time based on your experience with the other Newhouse publications and your investigation during the period of the acquisition, determine what percentage of the total circulation was of paid subscribers and the revenue was of paid subscribers and what percentage of the revenue came from advertising?

A Yes. We had information that Whitney had us do what the total circulation revenue was and what the total advertising revenue was.

Quite traditional, about 80 percent advertising revenue and 20 percent circulation revenue, and we had information from public sources that showed many paid subscribers Booth had, and in our discussions with the then CEO of Booth we ascertained that what we would expect as to the division of circulation revenue between paid subscribers and single copy was, in fact, what the division was.

Q And was that 80-20, 80 percent of the total revenue from [519] advertising, and 20 percent from circulation and subscribers and single copies, was that in conformity with your experience generally throughout the country at that time?

A Generally.

It varied between major metropolitan market newspapers such as the Star-Ledger would be and papers of the size of the Booth group, but generally the 80-20 would be normally what would be expected.

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PROCEEDINGS ON ORAL MOTION TO DISMISS BY COUNSEL FOR THE UNITED STATES

(February 7, 1990)

[526] MR. HREBINIAK: Yes, your Honor.

Pursuant to Rule 41(b) of the Federal Rules of Civil Procedure, the defendant moves for involuntarily dismissal of plaintiff's case on the ground that under the facts and law, under the facts presented by plaintiff and the applicable law, that plaintiff has not carried its burden of proof.

First, plaintiff clearly has the burden of proof. Its burden includes the burden of showing that the asset that they were trying to depreciate had a value, that that value is separate and apart from goodwill, and then if it were, that it had a ascertainable useful life.

I believe that the facts have shown that the asset is, as a matter of fact and as a matter of law, not separate and apart from goodwill, the asset as they have characterized it, that in fact the asset has been valued in a way that does not give credibility or weight or substance sufficient to carry their burden of proof, that there were severe problems with the valuations, as we have pointed out in the trial and, finally, that in fact, plaintiffs have not even come close to proving an ascertainable useful life.

They merely showed that it would be useful for the newspapers for some 40 to 50 years or perhaps even further. There was never any connection made between Mr. Glasser's report and in fact a useful life.

[527] And I think that under the case laws—the case law, number one, there have been the assets themselves, there has been no introduction of any evidence to show in fact it was an intangible asset, the type of which is normally depreciated under all of the cases.

There is no contract, there is no copyright, there is no patent. There is only a relationship.

I think the evidence was clear that this relationship was strictly the one between the customer and the paper,

and it was the likelihood that the customer would return to the paper.

They isolated a finite group of customers and proved statistically that this finite group of customers would disappear and eventually no longer be subscribers, but that does not carry the burden of proving that that is not merely the subset of goodwill.

Any part of goodwill can be broken apart and subsets of goodwill can be had.

The burden of proof was to prove that this asset was separate and apart from goodwill, that the relationship was separate from the mere relationship of a customer coming back to the place of business.

And as far as the evaluation, we—without getting into it more specifically, I think—

THE COURT: Let me try a hypothetical on you that I [528] have not done before.

Do you distinguish, if we go back to the real estate analogy between month-to-month tenants and tenants on fixed leases,—

MR. HREBINIAK: Uh-huh.

THE COURT: —would you say that you could not use the income approach, because month-to-month tenants are not committed to stay for any fixed period of time?

MR. HREBINIAK: The asset would have, since there was no contract or no lease, there was a tenancy at will. I can't imagine how the owner could or for how long he could predict that someone would stay in the apartment.

Again, I am sure a statistical study could be done of a group of people, and they can say on the average they stay five years or ten years.

THE COURT: Before we get to whether it has a fixed or determinable life, you suggested in some of your arguments that the reason you cannot distinguish this from goodwill is because there is no firm commitment from the subscribers to continue buying, not that in reality they may continue, but there is no contractual obligation.

Do you say that that is an essential which the plain-

tiffs must prove that there is some firm commitment by one or more consumers?

MR. HREBINIAK: Yes.

[529] I would have to say that at least there is—there has to be some sort of firm commitment.

THE COURT: Then I go to my month-to-month tenant, where obviously there is no commitment on the part of the tenant to continue the relationship, do you say in evaluating that real estate, you would not take into consideration the rent being generated and the expectation that they would continue?

MR. HREBINIAK: Absolutely not. That has great value.

I think one of the misconceptions is that the Government here is not contesting the value of customers.

And in that case we would not at all contest the value to a buyer of that building of the fact that this building has been rented continuously and that the prospects in the future are good.

But if they are merely month-to-month tenants, and he has to be very careful because it is probably the goodwill of that building that is keeping him there, the likelihood that they will return.

He doesn't mean that he won't pay as much for the building.

THE COURT: But the point is, if you include the month-to-month tenant income, using the income approach and you arrive at a value of the building, that would then be [530] the basis for the depreciation, would it not?

MR. HREBINIAK: An excellent complicated question, and I am afraid I am falling short.

THE COURT: Think about it. It is late in the day.

Let me say this in respect to the motion and I will not require any response.

I will reserve on the motion and I will decide it after the conclusion of the Government's case.

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TESTIMONY OF JOSEPH P. BANIEWICZ

(February 8, 1990)

VOIR DIRE

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[569] Q Now, your report is a valuation of lists only, subscriber lists. Isn't that correct?

A Correct.

Q It's not a valuation of subscribers—of the paid subscribers of the Booth newspapers as of May 31, 1977, isn't that correct?

A Correct.

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DIRECT EXAMINATION

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[593] THE COURT: Let me see if I understand it.

Let's take a weekly. Suppose you have a free weekly and a paid weekly in a community, each for 30,000 subscribers.

Is it your opinion that the value of the list in both of those instances would be the same, that you would not have differentiated between those subscribers who were paying $5 a week to those who were paying nothing?

THE WITNESS: The amount that a paid subscription is—is—is worth, is the goodwill or preference or the custom that that customer has with the paper.

Now, a free paper, it's just delivered at the door. You don't know if there is a preference or not.

In a paid weekly there would be a value to the paid, but that would also be—be—be included in [594] goodwill, the fact that that anybody had a position with those customers that they were actually willing to pay for the weekly paper.

THE COURT: In answer to my question, you would say that in evaluating the subscriber list, using your term, for the free weekly and paid weekly, same number

of subscribers, that the value would be the same, assuming it is the same community, same subscribers?

THE WITNESS: There isn't a subscriber list because there is no collection of subscriptions.

THE COURT: All right. Delivery list we will call it.

THE WITNESS: There is probably a delivery list in neighborhoods, but I don't think the households are identified. Just goes down the street and—

THE COURT: There has been some testimony that advertisers even with free papers target certain areas and are interested in certain areas, but taking my hypothetical, one is free, one paid, in your opinion, there would be no difference if you could identify the subscribers in both instances?

THE WITNESS: In the hierarchy of weeklies, a paid paper is worth more because it has a higher level of going concern and goodwill, so that is an element of value in the fact that the advertiser understands that there are people [595] that are willing to pay for it, if they are willing to pay for it. They are going to read the paper—

THE COURT: Does it make the list more valuable?

THE WITNESS: There is no list in free circulation. The list is just a tool. That is just a list in facilitating delivery—the delivery to the identfied subscribers in a paid situation.

THE COURT: What about catalogs, aren't they aimed at designated subscribers even though they come free?

THE WITNESS: Yes.

I think I identified the cost in the paid subscriber of establishing that list.

I mean I am putting a value on the list. There is a value to that.

THE COURT: But my question is: Is the value different if the person is paying for the magazine or getting it free?

Is there any difference in your valuation of the subscriber list?

THE WITNESS: If they are paying?

THE COURT: Yes.

THE WITNESS: In terms of the list, no.

THE COURT: All right.

THE WITNESS: There is additional value, but it's not attributable to the list.

[596] It's attributable to the preference of the consumer to read the paper. In a paid situation, it's going to have a higher goodwill value, because the prevalent—the preference of the customer to read the paper is evidenced by the fact that he is paying for that ability to read it, as opposed to a free list where he is not paying anything, but that is different from the list.

THE COURT: Suppose—the Houston case involved, did it not, the acquisition of a newspaper with no expectation of continuing its operations, but making use of the list of subscribers, right?

THE WITNESS: Well, it was sold to a surviving paper which was going to use it in the going concern.

THE COURT: If you were just buying a subscriber list for the purpose of making a solicitation, do you mean that a subscriber list of people who get something free as opposed to those who pay for it, has the same value, assuming you were not going to continue the operation of a magazine or newspaper?

THE WITNESS: First of all, a newspaper—in a free distribution newspaper they are just distributed to the general area.

THE COURT: That is why I said the magazine.

THE WITNESS: It's different from the magazine. That is a different question.

[597] The economics of competition and having a franchise are different.

That list may be very valuable in terms of selling it, because you targeted people in a very competitive environment that would be—but in terms of the free versus paid circulation, the paid organization is worth more, but the value goes into the customer relationship that the customer has the preference to read and the paying for

the paper is a stronger evidence of that preference and, therefore, that relationship is worth more, but that relationship is the goodwill.

The list is just a tool, the names and addresses, and the thing that facilitates the delivery to the paid customer. It's not the customer relationship.

THE COURT: All right.

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[621] Q —how did you describe the assets you were valuating?

A It was the subscription list which was the names and addresses of paid subscribers which facilitated the continuous and regular delivery of the paper to the subscribers.

Q Did you understand that the plaintiff used a different asset?

[622] A Yes.

Q And did you consider doing another evaluation?

A No. Because conceptionally I identified what they identified as being part of goodwill.

Q Okay.

Let's see.

Based on the cost approach, and based on your expertise and your background, training and experience in investigation, are you able now to express an opinion as to the fair market value of the subscriber lists of the Booth newspapers as of May 31st, 1977?

A Yes.

Q And what is that opinion?

A That the subscription lists were worth $2,296,763.

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CROSS EXAMINATION

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[637] Q I want to ask you this: The marginal subscribers are harder to get, it costs more to get them, to entice them into a new subscription, right?

A Correct.

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[638] Q Now, let me ask you to step away from this valuation exercise for a minute and talk to us about valuation concepts.

You heard Mr. Grabowski's testimony sometime earlier in the week, I can't tell you what day it was, but it was probably Monday, when it was direct testimony, when he talked about the fact that cost is an indicator of value, but in his judgment sometimes cost does not reflect value.

Do you remember that part of his testimony?

A Correct.

Q And do you remember that he used the example of a company that—that belonged, I think, to his uncle and he hired a young chemist right out of school, and he discovered some new process and they patented it, and the cost of creating the patent was really very low, but the value to the company, because it could be licensed or because it could be used, was very high. Do you remember that?

A Correct.

Q Would you agree in that situation that the cost was not a good indicator of value and—just there was not a good link between cost and value?

[639] A Yes.

Q Now, in your mind, as I understand it, you said you discounted your cost because it's easier to get the loyal subscriber or the seasoned subscriber, or whatever we call them, the regular subscriber from the costs that you had to work with, which were the costs of getting the marginal subscriber. Is that correct?

A Correct.

Q Now, you also said, as I recall, both in your report on page 24 and in your testimony in your deposition, that marginal subscribers are less valuable than existing or regular subscribers, isn't that right, because they have a lower retention rate?

A Correct.

Q And you said that in your report, didn't you?

A That is correct.

Q And you said it in your disposition, and you said it—you believe it today, right?

A In terms of the value, isn't the value—when I refer to "value," isn't the value that they are on the subscription list.

That value is the value of the relationship between them that would be included in goodwill as opposed to the subscription list.

Q But the total value of subscriber X, of the subscriber [640] who has been with this paper for ten years and will stay for ten more is a lot more than the value of Mr. Y, who they had to beat over the head to take a subscription and leave in a month, right?

A You are absolutely correct.

Q Okay.

And a buyer is going to want the first subscriber more than the second, isn't he, isn't he?

A Yes.

Q Okay. Because he is worth more, right?

A Right.

Q I am not talking about where you—what box you put it in, whether you call it goodwill or something else, he is more valuable, right?

A Correct.

Q And he is more valuable to the seller and he is more valuable to the buyer. Isn't that correct?

A Correct.

Q Now, so cost doesn't always equal value because the marginal subscriber cost more but is worthless, isn't that right?

A In terms of the—

Q I don't care about terms.

A In terms of the subscription list depends what you are looking at.

[641] Q I am talking value.

MR. HREBINIAK: Objection. Mr. Turkus is interchanging value. If he would specifically refer to what value he means, the value of the entire business as a going concern or the value of the subscription lists.

Those are two obvious things, and if he would ask the questions in those contexts, there would be no confusion.

THE COURT: I think he made it clear he was not asking for any allocation now, just talking value in the abstract. Is that correct?

MR. TURKUS: Absolutely.

THE COURT: With that understanding, can you answer the question?

THE WITNESS: In terms of total value, the value of the loyal subscribers—if you would include him—if you would include the value of the subscription lists and the goodwill, the amount of value between the two would be greater in the loyal subscriber in the combination of the two.

But in the list, it's just getting your name on there and getting the address, so the company knows where to deliver the paper.

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[643] Q Now, if you are going to determine value there, you just finished telling me the seasoned subscriber is a whole lot more valuable to everybody, buyer, seller and operator than the marginl subscriber, right?

A Right. And if you couldn't possibly put that relationship into goodwill—

Q I didn't ask you that. I just said it's more valuable, isn't it?

Forget about where you put the value. It's more valuable, isn't it?

A Yes.

Q And the cost approach that you used tells us and tells the Court that the marginal subscriber is the more expensive, doesn't it?

A Correct.

Q So if there is something about pure analysis that puts a [644] higher cost value on the less overall valuable subscriber, wouldn't you agree?

MR. HREBINIAK: Objection. Is this a continuing assumption?

THE COURT: Yes.

MR. TURKUS: In the context of that hypothetical yes. I apologize.

A I think what I am saying is that the cost of getting that marginal subscriber to be on the list takes more solicitation effort, is a costlier process and is the thing, if you are approaching the subscription list, makes it a higher cost.

• • • •

Q Mr. Baniewicz, forget about what basket you put it in.

In terms of overall value to the enterprise, value is part of an ongoing enterprise.

The seasoned subscriber is more valuable to the buyer, seller and operator than the marginal subscriber?

A Yeah.

Q Your analysis on the cost approach you used places a higher cost on the marginal subscriber and under your [645] analysis, a higher value on the marginal subscriber, does it not, in whatever basket you put it?

A It puts a higher cost in getting that subscriber on the subscription list.

Q You say that is his value, don't you? You equate cost with value?

THE COURT: Do you want the question repeated?

A In terms of getting him on the subscription list, yes.

Q That is the total value you put on the subscriber in your analysis, you say the other value goes into goodwill, but you don't value that as a separate asset, right?

A No. I—I don't value that in terms of the subscription list.

I mean, I recognize what you are saying is paid subscriber and you are calling something that I would identify as the relationship between the subscriber and the company and desire to take the newspaper.

A seasoned subscriber is more valuable to the company than one that is a marginal subscriber, but that doesn't

mean that if you are going to just reproduce the list, that the marginal cost of getting people that are not sure if they are going to take the paper is going to be higher, and is going to be—if you look at just the lists, which is the names and addresses of the subscribers, that is the asset that enables the company to deliver that paper on [646] a continuous and regular basis. That is the value of the subscription list as opposed to this seasoned customer relationship of a seasoned subscriber which is part of the asset of goodwill.

Q You said—

A Correct.

Q All right.

Now, you say that the subscription list is evidence of the relationship, right, didn't you?

Isn't that your direct testimony?

A All it is is a tool for the company to—I think what I have said is—I am not quite sure I put it in those terms.

I think I said, it is the subscription list which is the names and addresses of the subscribers, which enable the company to deliver the paper to its subscribers.

Q And the names and addresses are evidence of the relationship, are they not?

Didn't you say that before in your direct testimony?

A Yes, it's evidence, but that isn't—

Q It's a simple question. Let me ask you again and ask you to answer yes or no.

Are the names and addresses evidence of the relationship?

A Yes.

[647] Okay.

And you would agree that the seasoned subscriber relationship is more valuable to the enterprise than the marginal subscriber enterprise, wouldn't you?

A Yes.

• • • •

[666] Q Mr. Baniewicz, as I understood your deposition and this is a different topic, it won't be nearly as difficult for us to deal with.

As I understood your deposition testimony, you said if in the newspaper incidence, no more peas and peaches, in the newspaper example, if the subscriber had 20 year contracts, then you could and should use the incremental income approach to value and depreciate those contracts or subscriber relationships. Is that correct?

A Yes. I think you would have to look at your definition of income, though.

An income in that case, if—would be more like a lease.

If you had people contracted for twenty years, you would definitely have a useful life, so that wouldn't be a problem.

• • • •

TESTIMONY OF ARTHUR SHENKIN

(February 8, 1990)

VOIR DIRE

• • • •

[687] Q Let me ask you about—you did in your report instead a cost based valuation of the subscription list. Isn't that [688] right?

A Yes.

Q That was a subscription list, not subscribers?

A Yes.

• • • •

DIRECT EXAMINATION

• • • •

[713] What was the fair market value that you concluded for the asset that you valued?

A $1,250,000.

• • • •

CROSS EXAMINATION

• • • •

[715] Mr. Baniewicz I think would tell you that marginal subscribers are harder to attract as subscribers, because they have less interest in subscribing than seasoned subscribers.

Would you agree with that concept?

A Yes.

Q So is it harder to—do you agree with Mr. Baniewicz that it is harder to attract marginal subscribers to entice them into subscribing?

If you took two hypothetical potential subscribers, one who had the characteristics of a marginal subscriber and the other who had the characteristics of a seasoned subscriber, and you wanted to attract them to become new subscribers, would it cost more—would you agree with

Mr. Baniewicz it would cost more to attract the marginal subscriber?

A Yes.

• • • •

[719] Q Mr. Shenkin, would you agree with Mr. Baniewicz that the seasoned subscriber, because he will stay longer, brings more value to the total enterprise than the marginal subscriber who will drop off soon?

A Yes.

• • • •

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

Civil Action No. 88-4836-HLS

Honorable H. Lee Sarokin

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY,
Star Ledger Plaza, Newark, New Jersey 07101,
Plaintiff,

vs.

THE UNITED STATES OF AMERICA,
Defendant.

INTERIM ORDER

WHEREAS, this matter was originally brought before this Court on a complaint filed on November 9, 1988, in which the Plaintiff, Newark Morning Ledger Co. ("Morning Ledger"), asserted a right to a refund of federal taxes and interest paid for taxable years 1977 through 1980; and

WHEREAS, Morning Ledger's claims were based upon a number of asserted errors by the Internal Revenue Service in the processing of the tax returns of The Herald Company ("Herald"), a predecessor in interest to Morning Ledger, including the following (1) erroneous determination of the total adjusted basis in the assets acquired by Herald in the liquidation of Booth Newspapers, Inc. ("Booth") into Herald which occurred on May 31, 1977; (2) erroneous determination of the fair market values of certain of the assets distributed in the liquidation, namely, Booth's stock in Parade Publications, Inc., "going concern value," newspaper subscribers, and goodwill; (3) erro-

neous interpretation and application of the law with respect to how total adjusted basis is allocated to the property distributed in liquidation, leading to an incorrect determination of the adjusted basis in each of the assets acquired by Herald in the liquidation of Booth; and (4) erroneous determination that the values attributable to "going concern" and newspaper subscribers were non-depreciable; and

WHEREAS, in an effort to reach a partial settlement of these disputes between the parties, on October 12, 1989, Morning Ledger proposed a partial settlement of the issues to the United States; and

WHEREAS, the Internal Revenue Service has informed counsel for the Government that it finds the partial settlement proposed by Morning Ledger to be acceptable, and that it does not choose, nor has it authorized the counsel for the government, to litigate the issue concerning the inclusion in the adjusted basis of interim earnings and profits due to depreciation recapture; and

WHEREAS, the Government's position is consistent with the law as stated by the Tax Court and the Third Circuit governing the allocation of basis to assets acquired in liquidations such as that in this case; and

WHEREAS, counsel for the Government is unable to indicate to the Court today the Government's final position, either accepting or rejecting the proposed partial settlement despite numerous representations to this Court that final action by at least the Justice Department would occur prior to the scheduled trial date;

NOW, THEREFORE, it is on this 8th day of February, 1990 hereby

ORDERED, that Morning Ledger shall not be allowed any depreciation deduction for the going concern value of the Booth newspapers acquired in the liquidation on May 31, 1977; and it is further hereby

ORDERED, that Morning Ledger shall only be allowed an additional allocation of basis to the assets acquired in the liquidation of Booth in the amount of $14,176,000 pursuant to § 1.334-1 of the Treasury Regulations; and it is further hereby

ORDERED, that the fair market value of the Stock of Parade as of May 31, 1977, is determined to be $100,000,000; and it is further hereby

ORDERED, that the assets acquired by Herald in the liquidation of Booth are found to have the following fair market values and adjusted bases as of May 31, 1977:

Asset	Value	Basis
Cash & Equivalents	$ 15,617,042	$ 15,617,042
Securities	37,249,852	39,134,189
Accounts and Notes Receivable	15,046,899	15,046,899
Master Repurchase Agreements	3,100,000	3,100,000
Deferred Charges & Deposits	323,944	340,331
Inventories	3,435,627	3,609,423
Land	4,658,885	4,894,561
Land Improvements	1,721,959	1,809,067
Buildings and Improvements	21,350,237	22,430,269
Production Equipment	17,109,130	17,974,620
Computer Hardware	1,300,435	1,366,219
Furniture & Fixtures	880,775	925,330
Office Equipment	731,195	768,184
Autos & Trucks	234,489	246,351
Stock of Parade	100,000,000	105,058,644
Computer Software	1,658,000	1,741,872
Newspaper Subscribers, Going Concern Value and Goodwill	89,578,685	94,110,152
	$313,997,154	$328,173,154

and it is further hereby

ORDERED, that Morning Ledger is or may be entitled to certain refunds of taxes and interest solely by virtue of the foregoing paragraphs of this Order, and the parties are hereby directed to prepare a Stipulated Order for signature by this Court based upon agreed-upon calculations of such refunds of taxes and interest due, as set

forth in paragraph 31 of the Final Pretrial Order in this matter; and it is further hereby

ORDERED, that this order shall be merged into any final order and judgment entered in this proceeding.

/s/ H. Lee Sarokin
HONORABLE H. LEE SAROKIN

Dated: February 8, 1990

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY

Civil Action No. 88-4836-HLS

THE HONORABLE H. LEE SAROKIN

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY,
Star Ledger Plaza, Newark, New Jersey 07101,
Plaintiff,

v.

THE UNITED STATES OF AMERICA,
Defendant.

JUDGMENT

[Filed May 25, 1990, Entered on Docket May 31, 1990]

In accordance with the Opinion filed by the Court on April 3, 1990, judgment is hereby entered in this action in favor of Plaintiff Newark Morning Ledger Co. and against Defendant United States of America for a refund of federal income taxes and interest erroneously, unlawfully, and wrongfully assessed and collected in the following amounts for the years indicated:

1. For calendar and taxable year 1977, judgment is entered for Plaintiff against Defendant for refund of federal income taxes of $2,645,442, for refund of interest previously paid of $2,778,479, for a total amount of $5,423,921, plus interest from the date of payment of such amount as provided by law.

2. For calendar and taxable year 1978, judgment is entered for Plaintiff against Defendant for refund of federal income taxes of $2,041,903, for refund of interest previously paid of $2,070,793, for a total amount of

$4,112,696, plus interest from the date of payment of such amount as provided by law.

3. For calendar and taxable year 1979, judgment is entered for Plaintiff against Defendant for refund of federal income taxes of $2,013,154, for refund of interest previously paid of $2,283,242, for a total amount of $4,296,396, plus interest from the date of payment of such amount as provided by law.

4. For calendar and taxable year 1980, judgment is entered for Plaintiff against Defendant for refund of federal income taxes of $1,921,080, for refund of interest previously paid of $1,790,911, for a total amount of $3,711,990, plus interest from the date of payment of such amount as provided by law.

This judgment hereby incorporates the Interim Order entered by the Court on February 8, 1990, and thus resolves all claims between the parties. This judgment shall be deemed a final and appealable order in all respects as provided for in Rule 54(a) of the Federal Rules of Civil Procedure.

/s/ H. Lee Sarokin
H. LEE SAROKIN
U.S.D.J.

Date:

I hereby consent to the form of this Order.

UNITED STATES OF AMERICA

By: /s/ Gregory S. Hrebiniak
GREGORY S. HREBINIAK, ESQUIRE

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY

Civil Action No. 88-4836-HLS

THE HONORABLE H. LEE SAROKIN

NEWARK MORNING LEDGER CO., AS SUCCESSOR TO THE HERALD COMPANY, Star Ledger Plaza, Newark, New Jersey 07101,
Plaintiff,

v.

THE UNITED STATES OF AMERICA,
Defendant.

AMENDED JUDGMENT

[Filed June 4, 1990, Entered on Docket June 7, 1990]

In accordance with the Opinion filed by the Court on April 3, 1990, judgment is hereby entered in this action in favor of Plaintiff Newark Morning Ledger Co. and against Defendant United States of America for a refund of federal income taxes and interest erroneously, unlawfully, and wrongfully assessed and collected in the following amounts for the years indicated:

1. For calendar and taxable year 1977, judgment is entered for Plaintiff against Defendant for refund of federal income taxes of $2,645,442, for refund of interest previously paid of $2,778,479, for a total amount of $5,423,921, plus interest from the date of payment of such amount as provided by law.

2. For calendar and taxable year 1978, judgment is entered for Plaintiff against Defendant for refund of federal income taxes of $2,041,903, for refund of interest

previously paid of $2,070,793, for a total amount of $4,112,696, plus interest from the date of payment of such amount as provided by law.

3. For calendar and taxable year 1979, judgment is entered for Plaintiff against Defendant for refund of federal income taxes of $2,013,154, for refund of interest previously paid of $2,283,242, for a total amount of $4,296,396, plus interest from the date of payment of such amount as provided by law.

4. For calendar and taxable year 1980, judgment is entered for Plaintiff against Defendant for refund of federal income taxes of $1,921,080, for refund of interest previously paid of $1,790,911, for a total amount of $3,711,990, plus interest from the date of payment of such amount as provided by law.

This judgment hereby incorporates the Interim Order entered by the Court on February 8, 1990, and thus resolves all claims between the parties, which were the subject of this action. This judgment shall be deemed a final and appealable order in all respects as provided for in Rule 54(a) of the Federal Rules of Civil Procedure.

/s/ H. Lee Sarokin
H. LEE SAROKIN
U.S.D.J.

Date: June 4, 1990

I hereby consent to the form of this Order.

UNITED STATES OF AMERICA

By: /s/ Gregory S. Hrebiniak
GREGORY S. HREBINIAK, ESQUIRE

(15)

No. 91-1135

Supreme Court, U.S.
FILED
JUN 5 1992
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF PETITIONER NEWARK MORNING LEDGER CO.

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June 5, 1992

QUESTION PRESENTED

Whether the Third Circuit, in acknowledged conflict with other circuits and the United States Tax Court, was correct that under the Internal Revenue Code an income-producing, wasting intangible asset may be nondepreciable "goodwill" as a matter of law.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

No. 91-1135

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF PETITIONER NEWARK MORNING LEDGER CO.

Petitioner Newark Morning Ledger Co. respectfully requests that the judgment of the United States Court of Appeals for the Third Circuit (the "Third Circuit") be reversed for the reasons set forth herein.

OPINIONS BELOW

The opinion of the Third Circuit (Pet. App. at 1a-30a), as amended, is reported at 945 F.2d 555 (3rd Cir. 1991). The opinion of the United States District Court for the District of New Jersey (Pet. App. at 31a-51a) is reported at 734 F. Supp. 176 (D.N.J. 1990).

JURISDICTION

The judgment of the Third Circuit was entered on September 12, 1991. Rehearing *en banc* was denied (Circuit Judges Greenberg and Nygaard dissenting) on October 15, 1991. (Pet. App. at 52a-53a.) The Third Circuit stayed its mandate on November 14, 1991. The Petition for a Writ of Certiorari was filed on January 13, 1992, and was granted on April 6, 1992. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTE AND REGULATION INVOLVED

Section 167 of the Internal Revenue Code states in relevant part:

> (a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.
>
> . . . .

26 U.S.C. § 167(a) (1988).

The Treasury regulation interpreting section 167(a) states in relevant part:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

Treas. Reg. § 1.167(a)-3 (as amended in 1960).

STATEMENT OF THE CASE

Our federal income tax system has long recognized the right of a taxpayer to depreciate intangible assets that are useful in its business for a limited period of time. Prior to the decision of the Third Circuit in this case, courts uniformly allowed a taxpayer to depreciate its customer-based intangible assets so long as it established that the assets had limited useful lives, which could be estimated with reasonable accuracy, and ascertainable values separate from the residual goodwill value. The trial court in this case found that petitioner fully satisfied this factual showing.[1] The Third Circuit, however, created a contrary new rule of law: that at-will customer relationships acquired as part of an ongoing business are nondepreciable "goodwill." The Third Circuit's new rule of law is now before this Court.

A. Statement of Facts[2]

Petitioner Newark Morning Ledger Co. ("Ledger") is a newspaper publisher that is the successor to The Herald Company ("Herald"). (Pet. App. at 33a.) In 1976, Herald purchased substantially all the stock of Booth Newspapers, Inc. ("Booth"), a publisher of daily and Sunday paid circulation newspapers in eight Michigan communities. (Pet. App. at 34a.)[3] On May 31, 1977, Booth was merged into Herald. (Pet. App. at 35a.) As a result, Herald was required to allocate its adjusted tax basis in the Booth stock among the individual Booth assets in proportion to their fair market values

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1 Those findings of fact were neither challenged by the government, nor set aside by the Third Circuit, as clearly erroneous.

2 The facts are as found by the district court unless otherwise indicated.

3 The eight Michigan newspapers were the *Ann Arbor News*, *Bay City Times*, *Flint Journal*, *Grand Rapids Press*, *Jackson Citizen Patriot*, *Kalamazoo Gazette*, *Muskegon Chronicle*, and the *Saginaw News*.

as of the date of the merger. (Pet. App. at 35a.)[4] The Booth assets included cash and other financial assets, tangible and intangible property used in the business of the Booth newspapers, and the stock of a wholly-owned subsidiary corporation that published *Parade*, a nationwide Sunday newspaper supplement. (Pet. App. at 36a.)

As the government and Ledger stipulated, on the date of merger the total fair market value of the Booth assets was approximately $314 million. (Pet. App. at 35a.) Herald engaged the services of several experts to assist in determining the fair market value of each item of property. Based on the experts' appraisals and subsequent stipulations of the parties, approximately $224 million of the total fair market value of the assets was allocated among various financial, tangible and other property, and approximately $90 million was allocated to certain intangible property used in publishing the Booth newspapers. (Pet. App. at 36a.) Of the $90 million allocated to that intangible property, Herald allocated approximately $68 million to certain wasting intangible assets consisting of relationships with specific persons who subscribed to the Booth newspapers on the date of acquisition. (Pet. App. at 4a.)[5] The residual $22 million basis was allocated to going-concern value and goodwill. (Pet. App. at 37a.)

As of May 31, 1977, the Booth newspapers had 460,000 paid subscribers, each of whom was identified by name and address on records retained by the newspapers, their agents and/or contractors. (Pet. App. at 38a-39a.) The number of

4 Treasury Regulation § 1.334-1(c)(4)(vi)(b). For tax purposes, the fair market value of an asset is the price at which the asset would change hands between a hypothetical willing buyer and willing seller, neither being under any compulsion to buy or sell, and both parties having reasonable knowledge of relevant facts. Rev. Rul. 59-60, 1959-1 C.B. 237.

5 These subscribers had arranged to have daily and, in most instances, Sunday editions of the newspapers delivered to their homes by mail or by carrier, in consideration of payment of the periodic subscription price. (Pet. App. at 38a.) These subscribers with terminable-at-will contractual relationships are sometimes referred to as "paid subscribers." The term "paid subscribers" is intended to reflect the fact that the customers in question paid for their newspapers, rather than receiving them for free, and that they subscribed to the newspaper, requesting regular delivery, rather than purchasing it on a single copy basis.

paid subscribers was an important factor in Herald's decision to purchase Booth and in its determination of the purchase price for the Booth stock. (J.A. at 170-71.)

Most of the Booth paid subscribers were "seasoned," *i.e.*, subscribers who have taken the paper for a lengthy period of time. (J.A. at 67, 102, 168-69.) Because their purchases are regular and predictable, seasoned subscribers represent a reliable and measurable source of revenue for the newspaper. (J.A. at 108-11, 169.) In addition, because a newspaper's principal economic function is to provide a means for advertisers to convey their messages to prospective customers, the number of seasoned subscribers is of great importance to advertisers, and to the newspaper as well. (J.A. at 120-21, 126-28, 134, 160, 168-70.)[6] Consequently, a newspaper greatly values its seasoned subscribers. (J.A. at 111, 154.) Relationships with such seasoned subscribers are difficult to develop and replace. (Pet. App. at 40a-41a; J.A. at 139-51, 165-66.) A newspaper must make substantial efforts by way of circulation sales programs, market research studies, and product and service improvements to develop new subscribers. (J.A. at 76-78, 139-51, 165-66.)

Beginning in 1977, Herald claimed depreciation deductions under section 167 of the Internal Revenue Code[7] with respect to its paid subscribers. This allowed Herald to match the costs of acquiring the paid subscribers (the portion of the purchase price allocated to those subscribers) with revenues

6 Paid circulation newspapers such as the Booth newspapers have two primary sources of revenue: paid circulation, *i.e.*, sales of the newspaper itself, and sales of advertising. Approximately 80% of the total revenue of the Booth newspapers came from advertising sales. The remaining 20% of total revenue consisted of circulation revenue from the paid subscribers (approximately 85% thereof) and circulation revenue from coin box, newsstand and other sales. (Pet. App. at 37a-38a; J.A. at 75, 133, 170-71.)

Generally, advertisers prefer paid circulation over free circulation (due to the greater likelihood that the recipient will actually read the newspaper and see the advertising) and subscription-based circulation over single copy sales (because demographics and coverage are more easily measurable). (J.A. at 120-21, 134-35, 168.)

7 All citations to the Internal Revenue Code and the Treasury regulations are to the Internal Revenue Code and the regulations in effect during the relevant periods, unless otherwise indicated.

generated by them. Herald did not claim depreciation deductions with respect to intangible assets with indeterminable lives or unascertainable values, such as its relationships with advertisers and newstand purchasers and its reputation.

The Internal Revenue Service ("IRS") disallowed the depreciation deductions claimed for the years 1977 through 1980 with respect to the Booth newspapers' paid subscribers, asserting that those assets were part of goodwill and were, therefore, nondepreciable. Herald paid the additional taxes and interest, and Ledger, as successor to Herald, filed a claim for a refund. When the IRS failed to act on the claim within the Code-prescribed six-month period, Ledger filed suit in the United States District Court for the District of New Jersey to recover taxes and interest erroneously assessed and collected.

B. Proceedings Below

The case was tried to the district court from February 5 through February 8, 1990. Ledger and the government agreed that in order to prevail, Ledger had to establish that the subscriber relationships of the Booth newspapers have limited useful lives, the duration of which could be estimated with reasonable accuracy, and ascertainable values separate and apart from goodwill. (Pet. App. at 32a.)

Ledger presented three witnesses with regard to the first of these issues. Dr. Gerald J. Glasser, a statistician with considerable experience with media issues, described the process whereby, using generally accepted statistical techniques, he was able to estimate with the required accuracy the periods during which the paid subscribers would continue to subscribe, *i.e.*, the periods during which the relationships would be useful in the Booth newspapers' business. (Pet. App. at 41a-42a; J.A. at 60-63, 90-92, 94.) Dr. Christine D. Urban, a newspaper industry consultant specializing in circulation issues, and Mr. Werner Veit, Booth's president, supported Dr. Glasser's testimony in this regard, explaining the manner in which subscribers are lost and describing the considerable efforts involved in gaining new subscribers, thereby demonstrating that the paid subscribers do not simply "self-

regenerate." (Pet. App. at 37a-38a; J.A. at 74-78, 139-51; R. at 494-97.) Dr. Urban and Mr. Veit explained the benefits of acquiring seasoned subscribers, who tend to stay with a newspaper for a lengthy, predictable period, unlike marginal subscribers who are obtained through special promotional offers, but who often terminate their subscriptions after receiving the promotional premium. (J.A. at 150-51, 168-70.) The testimony of Dr. Glasser, Dr. Urban, and Mr. Veit was not contradicted, and the district court made the ultimate findings of fact that the paid subscribers would be useful in Ledger's business for only a limited period of time,[8] and that the useful lives of the paid subscribers were determinable with reasonable accuracy. (Pet. App. at 41a.)[9]

Ledger then presented expert testimony to establish that the paid subscribers of the Booth newspapers are separate from the goodwill of the papers. These expert witnesses offered uncontradicted evidence that the goodwill of the Booth newspapers resides in their reputation, their credibility and standing in the community, the quality of their service, and similar nonwasting or indeterminably lived attributes. (J.A. at 109-11; R. at 457-58.) Unlike the relationships with paid subscribers, the value of these attributes cannot be determined

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8 Specifically, the district court stated:

> It is undisputed that all the paid subscribers of the Booth newspapers as of May 31, 1977 would, at some point in time, no longer be subscribers. . . . Subscribers are lost because of death, relocation, lack of reader time or interest, changing lifestyles, and other factors that are beyond the control of the newspapers. Also, subscribers are lost due to dissatisfaction with the product or service and for various other reasons, including competition from other media sources such as radio, television, magazines and other paid-circulation and/or free distribution newspapers.

(Pet. App. at 40a.) The district court also found that the paid subscribers are not self-regenerating assets, meaning "there is no automatic replacement for a subscriber who terminates his or her subscription." *Id.* These facts distinguish the paid subscribers from goodwill, which "by definition, has an indefinite life . . . ." (Pet. App. at 45a.)

9 These findings, together with the district court's finding that the assets have ascertainable values separate from goodwill, triggered a stipulation of the parties as to the specific useful lives that should be used to depreciate the paid subscribers of each of the papers. (Pet. App. at 39a.)

by any direct measurement. (J.A. at 110-11, 164-65.) As a result, their value is appropriately determined using the residual approach, that is, by deriving the amount left after subtracting from the total purchase price the value of all assets that can be specifically identified and valued. (Pet. App. at 45a.)[10]

Based upon this evidence, the district court found that "[a]lthough newspaper subscribers are under no legal obligation to continue their subscriptions, expert opinion and the evidence presented coupled with common sense and experience leads inescapably to the conclusion that the income derived from such paying subscribers will recur, which, in turn, permits the ascertainment of value separate and apart from goodwill." (Pet. App. at 33a.) As the district court stated, the distinction between nondepreciable goodwill and the depreciable paid subscribers of the Booth newspapers is the distinction between "a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity of future purchases cannot be predicted" and "subscribers who can be predicted to purchase the same item, for the same price on a daily basis." (Pet. App. at 32a-33a.) Further elaborating on this point, the district court stated:

> [P]aid subscribers are distinct from previous customers who may or may not return, who may buy more or less or nothing at all. They are identifiable; how long they will remain as subscribers can be predicted with reasonable accuracy; and their value can be measured with a fair degree of accuracy. It is these unique characteristics which separates them from general goodwill and permits of a separate valuation.

(Pet. App. at 45a.)

Finally, Ledger's expert witnesses established the "fair market value" of the paid subscribers, *i.e.*, the price at which the paid subscribers would change hands between a hypothetical willing buyer and willing seller.[11] Ledger called two valuation experts, Messrs. Roger Grabowski and Larry D. Berkey, who identified the three common valuation methods: the market comparable, replacement cost, and income approaches. (Pet. App. at 42a; J.A. at 95-100, 162.) They then explained that the income method is the most appropriate for valuing the paid subscribers because actual buyers and sellers in fact would use that method in negotiating the price to be paid for customer-based assets of an ongoing business such as the paid subscribers. (Pet. App. at 43a; J.A. at 108, 162.)

The unchallenged testimony of Ledger's expert witnesses established that the market comparable approach could not be used in valuing the paid subscribers because there were insufficient sales of comparable property to form a basis for determining a market value. (Pet. App. at 42a; J.A. at 101, 162.) The cost approach also could not be used because there was insufficient evidence as to the cost of duplicating seasoned contractual relationships similar to those with the paid subscribers of the Booth newspapers. (Pet. App. at 42a-43a; J.A. at 67, 102-04, 121-23, 162.)[12] Accordingly, Ledger's

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10 The government stipulated that the fair market value of the Booth newspapers' goodwill and going concern value would be established using the residual method, *i.e.*, it would constitute the remainder of the total $314 million fair market value after value was allocated to all other tangible and intangible assets. (Pet. App. at 37a.)

11 In valuing the paid subscribers, petitioner examined only relationships with the 460,000 specific persons who were subscribers to the Booth newspapers on May 31, 1977. (J.A. at 54-55, 57-58, 72-73.) Although petitioner hoped that additional persons would subscribe to the papers after the acquisition, petitioner did not take such additional subscribers into account in identifying or valuing the asset. The life and value of the Booth newspapers' paid subscribers were based exclusively on the particular contractual subscriber relationships acquired on May 31, 1977. (J.A. at 112, 166.)

12 The government offered a cost approach valuation that estimated the cost of duplicating a "subscription list." (Pet. App. at 43a.) The government estimated the cost of replacing the physical list of subscribers as if it had been destroyed. (J.A. at 82, 85-86, 175.) It estimated that cost by determining the cost of soliciting an equivalent number of subscribers by means of outside sales organizations. (Pet. App. at 43a.) However, the evidence established that this was not the true cost of the paid subscribers of the Booth newspapers (Pet. App. at 42a-43a; J.A. at 122-23, 151-56, 169-70; R. at 494-97), and the government's witnesses admitted that the costs determined in their approaches were not equivalent to the value of the subscribers. (J.A. at 178-86.) The district court found that the government's witnesses "were unqualified, valued the wrong asset [a customer list as opposed to the paid

experts testified that the only valuation method appropriate for determining the fair market value of intangible assets such as the paid subscribers was the income method. (J.A. at 67-68, 105-06, 124, 129, 162.) The district court found that the income approach best reflects the method that buyers and sellers would utilize to determine the price of the paid subscribers. (Pet. App. at 43a-44a.)

Ledger's experts determined the fair market value of the paid subscribers to be nearly $68 million under the income method. (Pet. App. at 46a-47a.) Using that method, the experts determined the net economic benefit of the paid subscribers by calculating "the present value of the net revenue stream [the paid subscribers] would provide over their limited lives, *i.e.*, the subscription revenue less the cost of collecting that revenue." (Pet. App. at 44a, 46a.) Because all the other costs incurred in producing the newspapers would be incurred even if their circulation was by way of free distribution, the experts concluded that measuring this incremental profit was the best way to determine the fair market value of the paid subscribers. (J.A. at 105-08, 124-30, 135-39, 157-58, 159-60.) One of Ledger's experts, Mr. Berkey, testified further that he had tested and confirmed his valuation conclusion by another income approach in which value was determined by subtracting the relevant share of all costs, including the cost to produce the newspapers, from subscription revenue plus that portion of advertising revenue that was allocable to the paid subscribers. (Pet. App. at 46a; J.A. at 160-61.)[13] The government offered no evidence to challenge the valuation methods applied by Ledger's experts. (Pet. App. at 47a.) Accordingly, finding that Ledger's methodology "was fully in accordance with generally accepted valuation principles," the district court fully credited Ledger's valuation methodology and the

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subscribers] and utilized inappropriate methodology," and that the government's method "totally ignores the substantial efforts and expenses that had been invested over the years in establishing those subscriber relationships." (Pet. App. at 43a.) The district court therefore rejected the government's cost approach valuation.

13 This second approach is similar to that used by the taxpayer in *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987).

$68 million fair market value of the paid subscribers. (Pet. App. at 44a-45a, 47a.)

Thus, the district court found as fact that Ledger's terminable-at-will contractual relationships with its subscribers have limited useful lives, the duration of which was estimated with reasonable accuracy, and ascertainable values separate and apart from goodwill. (Pet. App. at 50a.) Based on these factual findings, the district court concluded that Ledger is entitled to claim depreciation deductions with respect to the paid subscribers. (Pet. App. at 50a.)

On appeal, faced with Ledger's unchallenged proof as to the wasting lives and separate values of the paid subscribers, the government argued that because the value of the Booth newspapers' relationships with its paid subscribers is based on the continued patronage of those subscribers, and because customer patronage is the essence of nondepreciable goodwill, the paid subscribers are part of goodwill and, as such, are nondepreciable. (Pet. App. at 7a.) In short, the government urged that a *per se* rule be grafted onto the provisions of section 167 of the Internal Revenue Code and section 1.167(a)-3 of the Treasury regulations that would deny depreciation for numerous wasting assets. Under the government's broad *per se* rule, any at-will customer-based intangible asset acquired as part of an ongoing business is nondepreciable.

The Third Circuit accepted the government's argument and, on September 12, 1991, reversed the decision of the district court. While the court of appeals accepted the trial court's factual findings that the paid subscribers have limited useful lives and ascertainable values (Pet. App. at 9a), it nevertheless held that the paid subscribers are not depreciable. (Pet. App. at 29a.) The Third Circuit concluded that, notwithstanding the unchallenged factual findings of the district court, Ledger *could not* have met its burden of proof, since the value of the paid subscribers acquired as part of an ongoing business was goodwill as a matter of law. (Pet. App. at 29a-30a.)

The Third Circuit placed decisional weight on the fact that the relationships between the Booth newspapers and their

subscribers are based in terminable-at-will contracts rather than contracts with fixed terms. (Pet. App. at 11a-12a.) The court held that patronage embodied in fixed-term contracts is not goodwill, and observed that "if the subscribers were contractually obligated to continue subscribing for some period of time, Ledger clearly would be permitted to depreciate the value of those contracts over that time period." (Pet. App. at 11a-12a.)

On October 15, 1991, the Third Circuit denied Ledger's petition for rehearing and suggestion for rehearing *en banc*. Two Circuit Judges, Greenburg and Nygaard, dissented. On April 6, 1992, this Court granted *certiorari*.

SUMMARY OF THE ARGUMENT

The income tax is a tax on *net* income. Taxable net income is determined by subtracting from revenues the expenses of producing those revenues. The expense of wasting business assets is taken into account by depreciating them over their useful lives. Thus, section 167 of the Internal Revenue Code ("Code") requires that there "shall be allowed . . . a depreciation deduction" for all wasting assets, tangible and intangible, that are used in a business or held to produce income. The assets in question here—Ledger's relationships with its subscribers—were found as fact by the district court to meet the statutory requirements for depreciability. Those facts were accepted by the Third Circuit.

Treasury Regulation 1.167(a)-3 ("regulation 1.167(a)-3"), which interprets section 167, expressly provides that an intangible asset with a life that "can be estimated with reasonable accuracy" is depreciable. The regulation disallows depreciation of "[a]n intangible asset, the useful life of which is not limited." "Goodwill" is identified as nondepreciable because it has an indeterminable life. Consistent with the statute, the regulation thus provides that whether an intangible asset may be depreciated depends entirely on whether its useful life can be estimated with reasonable accuracy. It is undisputed that the lives of Ledger's purchased subscriber relationships can be—and were—so determined.

The Third Circuit abandoned the unambiguous statutory and regulatory command that a wasting asset "shall be" depreciable. Instead, the court adopted a definitional approach to goodwill that imbued a traditional *description* of goodwill—"the expectancy that old customers will resort to the old place"—with a talismanic substantive force superior to the clear mandate of section 167. As a result, the court abandoned the statutory and regulatory criteria for depreciability and adopted a new *per se* rule: at-will subscriber relationships (and other such intangible customer-based assets) purchased as part of an ongoing business may not be depreciated even though their lives can be "estimated with reasonable accuracy."

This holding not only constitutes judicial rewriting of the tax law but is bound to cause unadministrable confusion. No one can be sure what assets may now be held to create the "expectancy" the court has substituted for the analytical approach of the statute and regulation. Goodwill is not a concept with a fixed content. It is a residual concept—the value that remains after the identifiable assets with determinable lives have been valued and subtracted from the price paid for a business. The only thing consistent about goodwill, until the Third Circuit's decision, is that it has an indeterminable life. That is goodwill's defining characteristic and, as the history of the regulation demonstrates, that is the only reason goodwill is not depreciable. Ledger's subscriber relationships do not share the defining characteristic of goodwill.

At least since the Fifth Circuit's seminal decision in *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), a decision that caused the government to abandon its prior position that all customer-based intangible assets were nondepreciable, taxpayers have acquired businesses with the reasonable expectation that such assets, with proven limited lives and ascertainable values, could be depreciated. Those settled expectations have now been upset. Worse, the Third Circuit's new rule would treat economically identical customer-based intangible assets differently by making wholly arbitrary distinctions between assets embodied in fixed-term rather than at-will contracts, between assets acquired separately rather

than as part of an ongoing business, and between assets valued pursuant to one commonly accepted valuation method as opposed to another.

These distinctions have nothing to do with the principles of economics or accounting, nor should they be arbitrarily thrust into the tax law. Such distinctions, as the government will surely concede, have nothing to do with the depreciability of tangible assets under section 167. Since section 167 treats tangible and intangible assets alike, these new and capricious Third Circuit distinctions may not determine whether intangible assets are depreciable.

ARGUMENT

I.

CUSTOMER RELATIONSHIPS THAT HAVE DEFINITE USEFUL LIVES AND ASCERTAINABLE VALUES ARE DEPRECIABLE UNDER SECTION 167 OF THE INTERNAL REVENUE CODE

In acquiring the Booth newspapers, Ledger paid $68 million for extremely valuable but wasting assets—the Booth newspapers' long-standing relationships with their subscribers. Those relationships have useful lives whose lengths were determined and whose values were ascertained. The district court so found, and the Third Circuit did not disturb those factual findings.

Given these facts, Ledger has the right, under section 167 of the Code, to depreciate those wasting assets so that the revenues generated by them are offset by Ledger's tax basis in acquiring them. This matching of gross revenue and costs to arrive at taxable net income is a fundamental principle of tax law. This case is controlled by that principle; its application to the undisputed facts requires reversal of the judgment below.

A. The Federal Income Tax Is A Tax On Net Income

It is a fundamental premise of the Internal Revenue Code that the income tax is a tax on net—not gross—income. This principle has long been axiomatic in the drafting and structure of the income tax laws. In furtherance of the goal of taxing only net income, Congress has incorporated into the income tax laws the concept of "matching" annual income with the annual expenses incurred to earn that income. This matching is necessary to achieve the accurate determination—and taxation—of net income.[14] As this Court recently stated, "the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." *INDOPCO, Inc.* v. *Commissioner*, 112 S. Ct. 1039, 1043 (1992).

B. Because Income Tax Is On Net Income, All Wasting Assets Used To Produce Income Are Depreciable

Section 167 is one of the principal provisions by which the Code matches income against expenses. It provides:

> There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income.[15]

Section 167 provides for the depreciation of a wasting asset over the useful life of the asset. *See INDOPCO*, 112 S.Ct. at

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14 The matching principle is explicitly embodied in Code sections 162 (deduction of ordinary and necessary business expenses), 167 and 168 (depreciation of capitalized costs), 441 (providing that taxable income shall be computed on the basis of a taxpayer's taxable year), 446 (method of accounting), 451 (taxable year for recognition of income), and 461 (taxable year for deductions).

15 The tax laws have included a deduction for depreciation of wasting assets since the first modern income tax statute. The listed deductions in the Act of 1913 included "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business. . . ." Act of October 3, 1913, Sec. II(B). Section II(G)(b) provided a similar deduction for corporate taxpayers.

1042 ("a capital expenditure usually is amortized and depreciated over the life of the relevant asset"). Were such depreciation deductions not allowed, a taxpayer would be taxed on more than net income because the full costs of producing the taxpayer's revenues in a given year would not be taken into account. *See Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96 (1960) ("It was the design of Congress to permit the taxpayer to recover, tax free, the total cost to him of such capital assets [that are wasting] . . . ."); *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 101 (1943) ("the machine in its lifetime must pay for itself before it can be said to pay anything to its owner").

Section 167 does not vest the IRS with discretion to disallow a depreciation deduction for wasting assets. To the contrary, the provision is mandatory, and directs that a depreciation deduction "shall be allowed" with respect to wasting property used in a business. *Northern Natural Gas Co.* v. *O'Malley*, 277 F.2d 128, 131-32 (8th Cir. 1960).[16]

Nor is section 167 limited to particular types of property. Instead, the provision applies to all property "used in the trade or business" or "held for the production of income." Such property includes both tangible and intangible assets. *Northern Natural Gas*, 277 F.2d at 131; *Manhattan Co. of Virginia, Inc.* v. *Commissioner*, 50 T.C. 78, 91 (1968).[17] In

16 Depreciation is also mandatory for the taxpayer. Code section 1016(a)(2) states that a taxpayer's cost basis is reduced by the amount of the greater of depreciation deductions allowed or "allowable." Thus, a taxpayer "entitled" to depreciate an asset *must* depreciate the asset, or face the unpleasant consequences when the asset is later sold and it is taxed as if it had properly depreciated the asset. That is, a taxpayer who fails to take depreciation deductions will nonetheless be forced by Code sections 1001 and 1016 to report gain on the difference between the selling price and the lower tax basis that it would have had in the asset if the proper depreciation deductions had been taken.

17 The government, in its rulings, has also recognized that there is no distinction between intangible and tangible property for purposes of depreciation. Rev. Rul. 68-483, 1968-2 C.B. 91-92, *modified*, Rev. Rul. 75-137, 1975-1 C.B. 74 ("Whether or not an intangible asset, or a tangible asset, is depreciable for Federal income tax purposes depends upon the determination that the asset is actually exhausting, and that such exhaustion is susceptible of measurement.").

sum, in order to effectuate the Code's basic goal of taxing only net income, *all* wasting assets used in a business are depreciable over the course of their useful lives.

1. The Subscriber Relationships Were Found To Be Wasting Assets With Determinable Lives

Based upon the testimony of expert statistician Dr. Gerald J. Glasser, other testimonial evidence regarding the limited lives of the subscribers, and the stipulation of the parties as to the limited lives for depreciation purposes if the district court found the assets were depreciable,[18] the district court found:

> Either based upon the inevitable death of the *subscribers* or the statistical evidence submitted by plaintiff and the uncontroverted expert opinions that the *subscriptions* have limited useful lives which can be estimated with reasonable accuracy, plaintiff has clearly established that the paying subscribers (or subscriptions) of the acquired newspapers had limited useful lives, the duration of which can be and has been estimated with reasonable accuracy.

(Pet. App. at 32a) (emphasis in original). This finding has never been contested by the government and was not upset by the Third Circuit on appeal.

2. The Subscriber Relationships Were Property "Used In The Trade Or Business" Or "Held For The Production Of Income"

Section 167 allows the depreciation of any wasting asset (1) "used in the trade or business" *or* (2) "held for the production of income." This broad language clearly includes the

18 Ledger and the government stipulated to specific separate useful lives for both the daily subscriber relationships and the Sunday subscriber relationships for each of the eight Booth newspapers. The lives of these 16 distinct groups of subscriber relationships ranged from a low of 14.7 years for both the daily and Sunday subscribers to the *Ann Arbor News* to a high of 23.4 years for the Sunday subscribers to the *Bay City Times*. (Pet. App. at 39a.)

subscriber relationships at issue here. Indeed, the government never asserted that the assets were not so used or so held.

First, the subscriber relationships are "used in the trade or business" because they are critical to the attraction of advertisers. Advertising revenues constitute approximately 80% of the total revenue of the Booth newspapers. (Pet. App. at 7a n.2, 38a.) Advertisers purchase advertising on a cost per thousand basis, so that a larger subscriber base generates higher advertising rates and greater revenues. (J.A. at 134-35.) Moreover, advertisers generally prefer paid circulation over free circulation (because of the greater likelihood that the recipient will actually read the newspaper and see the advertising), and subscription-based circulation over single copy sales (because demographics and coverage are more easily measurable). (J.A. at 120-21, 134-35, 168.) Thus, the subscriber relationships are a key asset "used in the trade or business" to attract advertisers. *See Donrey, Inc.* v. *United States*, 809 F.2d 534, 536 (8th Cir. 1987) (subscriber relationships are used in a newspaper business as "an indispensable tool in selling advertising"; asset held depreciable).

Second, the subscriber relationships are clearly "property held for the production of income." The 20% of Booth newspaper revenue not derived from advertising was derived from circulation. (Pet. App. at 37a-38a; J.A. at 75, 133, 170-71.) Approximately 85% of this circulation revenue was from subscribers; the remainder came from single copy sales. Thus, the subscribers produce income—and the subscriber relationships are business property held to produce income—within the meaning of section 167(a).

Though the Third Circuit accepted that the subscriber relationships were wasting, income-producing assets used in Ledger's trade or business, it held that the relationships were "goodwill" and thus not depreciable as a matter of law under regulation 1.167(a)-3. In denying the depreciation of a wasting asset, the Third Circuit ignored the dictates of section 167, misconstrued the Treasury regulation, and abandoned the fundamental precept that federal income taxation is a tax on net income.

C. "Goodwill" Is Cast As Nondepreciable Under The Treasury Regulation Only Because It Is Not A Wasting Asset With A Determinable Life

The Third Circuit's decision was based on a basic misconception as to the nature of "goodwill" for income tax purposes and the reason why it is described as nondepreciable under regulation 1.167(a)-3. Properly understood, goodwill is not a substantive concept that overrides the plain language of section 167 and renders nondepreciable certain wasting business assets with proven ascertainable lives. Instead, it is a residual concept that encompasses certain *non*wasting and indeterminably lived aspects of a business that remain after all identifiable tangible and intangible assets are valued. *See* Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 Harv. L. Rev. 859, 861 (1968) (goodwill is "the residual intangible asset"); McDonald, *Goodwill and the Federal Income Tax*, 45 Va. L. Rev. 645, 648 (1959) (goodwill is "the indefinable something left over"); Gen. Couns. Mem. 35,535 (October 30, 1973) ("we note the tendency to define goodwill in negative terms").[19]

1. All Intangible Assets With Ascertainable Limited Lives Are Depreciable Under Regulation 1.167(a)-3

The circumstances under which intangible assets are depreciable under section 167 are addressed by regulation 1.167(a)-3. Specifically, that regulation provides for the depreciation of an intangible asset if it is "of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy"; sets forth patents and copyrights as examples of depreciable intangible

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19 Indeed, recent statutory and regulatory provisions expressly recognize that goodwill is not amenable to specific identification and valuation, but instead represents the residual value of an ongoing business over and above the fair market value of all identifiable assets—both tangible and intangible. *See* 26 U.S.C. § 1060; 26 C.F.R. §§ 1.338(b)-2T(b)(2), 1.1060-1T(d). These provisions codify the government's longstanding preference for using the residual method to value goodwill. *See* S. Rep. No. 313, 99th Cong, 2d Sess. 252 (1986). In this case, the government "stipulate[d] the residual method is the proper method" to value goodwill. (J.A. at 164-65.)

assets; provides for no depreciation of "[a]n intangible asset, the useful life of which is not limited"; and provides that "[n]o deduction for depreciation is allowable with respect to goodwill." Given section 167's overriding mandate that there "shall" be a depreciation deduction for all wasting business assets, the only permissible reading of regulation 1.167(a)-3 is that all assets with limited lives, "the length of which can be estimated with reasonable accuracy" (like patents and copyrights) are depreciable, and all assets whose "useful life . . . is not limited" (like goodwill) are not depreciable. Thus, the statement that goodwill is nondepreciable is not a substantive principle of law, but is merely an example of the proposition that an intangible asset without a limited life cannot be depreciated.[20] Indeed, Congress has repeatedly stated that it is only "because goodwill does not have a determinable useful life . . . [that] no depreciation deduction is allowed." H.R. Rep. No. 495, 100th Cong., 1st Sess. 936 (1987).[21]

The government and the Third Circuit lost sight of the congressional rationale codified in section 167, which controls the meaning of regulation 1.167(a)-3. The government argued, and the Third Circuit agreed, that goodwill is a substantive concept, the essence of which is "the expectancy that old customers will resort to the old place," and that an asset

20 To the extent that regulation 1.167(a)-3 purported to render nondepreciable a wasting asset properly depreciable under section 167 of the Code, it would be invalid. Section 1.167(a)-3 was promulgated pursuant to the Treasury Department's general authority under section 7805(a) of the Code to "prescribe all needful rules and regulations." Section 7805(a) is not a grant of substantive rulemaking authority or "a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision." *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 24-25 (1982) (*quoting Rowan Cos.* v. *United States*, 452 U.S. 247, 253 (1981)). Rather, it is merely an "interpretive" regulation and, as such, regulation 1.167(a)-3 cannot establish more stringent conditions for depreciation of intangible assets than those imposed by the clear language of the statute. *See Northern Natural Gas*, 277 F.2d at 133-35.

21 *See also* S. Rep. No. 144, 97th Cong., 1st Sess. 39 (1981) ("Land, goodwill, stock, and other assets that do not have a determinable useful life and that do not decline in value predictably are not depreciable."); H.R. Rep. No. 215, 97th Cong., 1st Sess. 206 (1981) ("Assets that do not decline in value on a predictable basis or that do not have a determinable useful life, such as land, goodwill and stock, are not depreciable.").

tinged with this expectancy is nondepreciable notwithstanding proof that the asset is wasting and has a determinable life. This reading of the regulation is not only at odds with the express terms of section 167, but is belied by the plain language of the regulation, the focus of which is the asset's wasting nature. Moreover, the notion that goodwill has any fixed substance—let alone a substantive force sufficient to render nondepreciable a wasting asset—is simply wrong. The only rationale for casting goodwill as an example of a nondepreciable intangible asset under regulation 1.167(a)-3 and its predecessor Treasury regulations is that goodwill was believed not to waste or to have a determinable life.

2. The History Of Regulation 1.167(a)-3 Demonstrates That Goodwill Is Nondepreciable Only Because It Has An Indeterminable Life

As noted above, under regulation 1.167(a)-3 all assets with proven determinable lives are depreciable and those with indeterminable lives are not depreciable; goodwill is not depreciable *because* it does not have a determinable life. This is evident from the history of regulation 1.167(a)-3.

The first set of official Treasury regulations that expressly provided for the depreciation of intangible assets was adopted in 1919. Regulations 45, T.D. 2831, Art. 163 (1919). Article 163 stated:

> Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. *If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance*, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. There can be no such allowance in

> respect of good will, trade names, trademarks, trade brands, secret formulae or processes.

Id. (emphasis added). Thus, intangible assets with limited lives (for example, patents and copyrights) were depreciable; intangible assets with indeterminable lives (for example, goodwill and trademarks) were not. Critically, the taxpayer was permitted to depreciate intangibles "known from experience to be of value in the business for only a limited period." The decisive inquiry was expressly made to turn on whether a given intangible asset had a limited life—demonstrated by a prescribed statutory period or by "experience."

Shortly after promulgation of Article 163, the Advisory Tax Board addressed the depreciability of goodwill in light of the passage of the Prohibition Amendment to the Constitution. T.B.R. 44, 1 C.B. 133, 134-135 (1919). Prohibition raised the prospect that the goodwill of an alcohol-related business might have a determinable life. Accordingly, while the Board acknowledged that, as a general matter, goodwill has no limited life, it recognized that the controlling principle for depreciation was whether the asset was *actually* wasting:

> [Article 163 of Regulations 45] states that "Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance." It is true that this same article states that no such allowance may be made in the case of intangibles of the class now under consideration [including goodwill], and while in general this negative decision is sound, *the controlling rule is the one quoted above, and when an item of intangible property falls within that rule it must be dealt with accordingly. [That is the] major rule laid down in [the regulation].*
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>
> *[W]hen it is demonstrated that the useful life of an intangible is definitely limited, such intangible then becomes a proper subject of depreciation allowance.*

Id. (emphasis added). Thus, the Board concluded that in limited circumstances, such as where an alcohol-producing business was to cease operations as a result of Prohibition,

goodwill might have an ascertainable, limited life so that a depreciation deduction for goodwill might be warranted. *Id.* The Treasury Department contemporaneously modified Article 163, and deleted the last sentence which stated, "[t]here can be no such [depreciation] allowance in respect of good will, trade names, trademarks, trade brands, secret formulae, or processes." T.D. 2929, 1 C.B. 133 (1919). Over the next several years, the Treasury Department expressly recognized that, in rare circumstances such as Prohibition, where the taxpayer could demonstrate that goodwill had a determinable life, it was, like all other intangible assets, depreciable.[22]

In 1927, relying on accounting principles, the Eighth Circuit noted in *Red Wing Malting Co.* v. *Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927):

> [Goodwill's] actual value changes from day to day and there would be so much uncertainty in any attempt to adjust its book value that by common consent it is left alone. . . . *As good will does not suffer wear and tear, does not become obsolescent, is not used up in the operation of the business, depreciation, as such, cannot be charged against it.*

Id. at 633 (quoting *Montgomery's Auditing Theory and Practice*) (emphasis added). Thus, the Eighth Circuit held that "[w]e are satisfied there can be no wear or tear of goodwill, or exhaustion thereof by use . . . ." *Id.*[23] Thereafter, the

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22 *See, e.g.*, O.D. 818, 4 C.B. 178 (1921) (goodwill and other intangibles with definitely limited lives because of Prohibition were depreciable; goodwill was not depreciable if the alcohol dealer continued in a similar trade or business, since goodwill would still have an unlimited life); O.D. 472, 2 C.B. 141 (1920) (goodwill was depreciable if the taxpayer could show that the business' goodwill would have no value at the end of a definite period because the business was forcefully terminated). Indeed, no less a jurist than Learned Hand twice ruled that goodwill was a depreciable intangible asset when proven to be wasting or obsolete. *See Williams* v. *McGowan*, 152 F.2d 570, 572 (2d Cir. 1945); *Haberle Crystal Springs Brewing Co.* v. *Clarke*, 30 F.2d 219, 222 (2d Cir. 1929), *rev'd on other grounds*, 280 U.S. 384 (1930).

23 The underlying issue in *Red Wing* was whether a business that discontinued its operations as a result of Prohibition was entitled to an obsoles-

Treasury Department changed its position by expressly adopting the *Red Wing* ruling, and amended the regulations interpreting the depreciation statute by adding the concluding sentence: "No deduction for depreciation, including obsolescence, is allowable in respect of goodwill." T.D. 4055, VI-2 C.B. 63 (1927). The Treasury regulations interpreting the depreciation statute have included such a provision ever since.

As the above history demonstrates, goodwill was cited as nondepreciable under the regulations only because it was believed not to waste. When it appeared that, due to the unusual circumstance of Prohibition, the goodwill of some alcohol-related businesses might actually have a determinable life, the regulation was amended to allow for the depreciation of goodwill. It was only after the Eighth Circuit held that goodwill had an indeterminable life for all businesses, regardless of Prohibition, that goodwill was again cast as nondepreciable in the regulations.[24]

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cence deduction under the predecessor to section 167 with respect to the goodwill lost upon such discontinuance. The court held that the allowance for obsolescence was limited to those assets that were subject to wear and tear on the date of purchase. Accordingly, having concluded that goodwill does not normally suffer wear or tear, no obsolescence deduction was permitted.

24 For the next sixty years, courts continued to adhere to the view that goodwill was nondepreciable solely because it was presumed not to waste. *See, e.g., Patterson* v. *Commissioner*, 810 F.2d 562, 569 (6th Cir. 1987) (goodwill "does not waste"); *Donrey*, 809 F.2d at 536 ("Goodwill is conclusively presumed to have an unlimited useful life"); *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 450 (Ct. Cl. 1976) ("Goodwill is . . . presumed to have a useful life of indefinite duration"); *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240, 1248 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) (goodwill is "an ongoing asset that fluctuates but does not necessarily diminish"); *Dodge Brothers, Inc.* v. *United States*, 118 F.2d 95, 100 (4th Cir. 1941) (goodwill is not depreciable "because of the manifest difficulties inherent in the computation of both the life span and the value of this intangible asset"); *Landsberger* v. *McLaughlin*, 26 F.2d 77, 78 (9th Cir. 1928) ("we think it clear that goodwill is not . . . subject to exhaustion, wear, or tear"); *Colorado National Bankshares, Inc.* v. *Commissioner*,

3. Goodwill Has Always Been A Fluctuating Concept With No Independent Force Under Regulation 1.167(a)-3

The Third Circuit's position that the subscriber relationships are not depreciable hinges on imbuing the word "goodwill" with a substantive force that is superior to the mandate of section 167. Indeed, the Third Circuit's decision is based entirely on the erroneous premise that a traditional *description* of goodwill—"the expectancy that old customers will resort to the old place"—creates an exception to the plain words of the Code. That remarkable conclusion apparently derives from the fact that this description of goodwill has often been repeated by rote. (Pet. App. at 11a, 16a, 23a-25a.) In fact, "goodwill" has no fixed content, let alone substantive force sufficient to abrogate the basic premise that taxation is imposed only on net income.

The notion that goodwill is the "expectancy that old customers will resort to the old place" was first espoused, not in any tax case, but by Lord Eldon in the 1810 British decision of *Cruttwell* v. *Lye*, 17 Ves. 335, 346 (1810). Because the defendant, who sold his business with its goodwill, had started a competing business at a new location, the court held that he had not appropriated the goodwill he had sold.

This Court also had occasion to grapple with the content of goodwill and, specifically, its application to newspapers in *Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436 (1893). This Court observed:

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60 T.C.M. (CCH) 771, 789 (1990) ("Goodwill, by definition, has an indefinite life . . . ."); *Illinois Cereal Mills, Inc.* v. *Commissioner*, 46 T.C.M. (CCH) 1001, 1023 (1983), *aff'd* 789 F.2d 1234 (7th Cir.), *cert. denied*, 479 U.S. 995 (1986) ("Neither goodwill nor going-concern value is subject to depreciation because the useful life is not susceptible of reasonable estimation"); *Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223, 233 (1975), *acq.*, 65 T.C. 1153 (1976) (goodwill "may be expected to continue indefinitely"); *Manhattan Co. of Virginia Inc.* v. *Commissioner*, 50 T.C. 78, 88 (1968) ("Goodwill has uniformly been held not to be subject to depreciation since it is not generally a wasting asset of the business to which it attaches, but rather an asset with an indefinite useful life").

> Undoubtedly, good will is in many cases a valuable thing, although there is difficulty in deciding accurately what is included under the term.

Id. at 446.

Subsequent to *Metropolitan Bank*, courts and commentators continued to recognize the elusive nature of goodwill. *See, e.g., People ex rel A.J. Johnson Co.* v. *Roberts*, 159 N.Y. 70, 80-81, 53 N.E. 685, 687-689 (1899) (collecting cases and treatises discussing the numerous definitions of goodwill); Wright, *The Nature And Basis Of Legal Goodwill*, 24 Ill. L. Rev. 20, 23-24 (1929) ("With the complex bases upon which goodwill rests, it is self-evident that, if we attempt to reduce goodwill to a simple, well-defined concept, we shall encounter difficulties.").[25]

The "definition" of goodwill which is the foundation of the government's position and the Third Circuit's decision is a misunderstood shibboleth dating back to 1810. While repeated by courts as a convenient, if imprecise, way to describe goodwill, this definition was framed for purposes irrelevant here, does not address the problems of the federal tax laws and is of no analytical use in the present case. In fact, goodwill and future patronage are not synonymous under the Code. Thus, it has been held that an operating business with continued customer patronage may have no goodwill for income tax purposes. *See, e.g., Montgomery Coca-Cola Bottling Co., Inc.* v. *United States*, 615 F.2d 1318, 1331-32 (Ct. Cl. 1980) (no goodwill in business operated pursuant to a franchise); *Zorniger* v. *Commissioner*, 62 T.C. 435, 444-445 (1974) (same); *Pensacola Greyhound Rac-*

25 The Third Circuit also noted (Pet. App. at 10a-11a, n.5) that the absence of a clear definition of goodwill has generated much criticism among the commentators. *See* Mundstock, *Taxation of Business Intangible Capital*, 155 U. Pa. L. Rev. 1178, 1206-07 (1987); Dubin, *Allocation of Costs to and Amortization of Intangibles in Business Acquisitions*, 57 Taxes 930, 933 (1979); Grigsby & Cotter, *Amortization of Certain Intangibles*, 30 U.S.C. Tax Inst. 543, 545 (1978); Gregorcich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 Tax Law. 251, 258-59 (1975); Frank, *Goodwill Is Not Immortal: A Proposal To Deduct the Exhaustion of Purchased Goodwill*, 23 J. Taxation 380, 380-81 (1965); Note, *An Inquiry Into the Nature of Goodwill*, 53 Colum. L. Rev. 660, 685-86 (1953).

ing, Inc. v. *Commissioner*, 32 T.C.M. (CCH) 1064, 1069 (1973) (no goodwill in monopoly or quasi-monopoly market). Here, of course, the Third Circuit admits that future patronage under fixed-term contracts is not goodwill. (Pet. App. at 112-122.) The only fixed aspect of goodwill that has roots in the federal income tax laws is that goodwill has an indeterminable life.

Unadministrable, vague and descriptive "definitions" of goodwill have no place in the implementation of our nation's revenue laws. They only sow unpredictability and confusion. Moreover, it is not necessary to define goodwill to resolve whether customer-based intangibles are depreciable. Instead, limiting goodwill to the non-wasting, residual attributes of a business is an easily-administered, predictable rule that is in accordance with the express terms of section 167, the underlying principles of the Code and modern-day economic and business realities.

4. The Government's Refusal To Adhere To The Principle That An Indeterminable Life Is The Hallmark Of Goodwill Has Permitted It To Take Positions Inconsistent With Its Own Revenue Rulings

The government has lost sight of the principle that the signature characteristic of goodwill is that it is nonwasting in favor of the amorphous notion that "goodwill is the expectancy that old customers will resort to the old place"—a homily that permits the government to assert that any intangible asset related to patronage is, *per se*, nondepreciable goodwill.[26] This approach ignores the reason why goodwill is

26 To this end, the government has repeatedly attempted to portray goodwill as a sacrosanct concept that taxpayers try to avoid by engaging in "shenanigans" with respect to depreciating wasting intangible assets. For example, in *Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990), the government complained that "tax benefits motivated petitioner to allocate as much of the purchase price [of a bank] to deposit base [intangible assets]," which constituted, according to the government, "self-serving accounting shenanigans." *Id.* at 493. The Tax Court resoundingly rejected the government's position, stating that "it is not improper for petitioner to attempt to minimize its tax liability. Respondent's [the government's] argument misses the mark." *Id.*

cast as nondepreciable and has permitted the government to take positions inconsistent with its own revenue rulings.

For example, the government has conceded that customer-based intangible assets, including insurance expirations, customer lists and subscription lists, are not *per se* goodwill, but are instead depreciable, provided the taxpayer can make the requisite factual showing that the assets are wasting and have values separate and distinct from goodwill. Rev. Rul. 74-456, 1974-2 C.B. 65.[27] Although the government has not revoked its rulings, it now urges that a host of customer-based assets be held nondepreciable goodwill as a matter of law.[28]

The government's reliance on hoary descriptions and vague notions that goodwill is connected to patronage, rather than on the regulation-based principle that goodwill is nonwasting, has resulted in the inconsistent treatment of wasting intangible assets. While the government may consistently quote its "old customers returning to the old place" standard, the government clearly has not consistently applied that standard to various classes of intangible assets.[29] The proper inquiry under section 167 is *not* whether the asset is somehow con-

27 The government has been equally inconsistent with its treatment of other wasting intangible assets under the depreciation statute, including covenants not to compete and fixed-term contracts. *See, e.g., U.S. Industrial Alcohol Co.* v. *Commissioner*, 42 B.T.A. 1323, 1344-45 (1940), *aff'd in part and rev'd in part*, 137 F.2d 511 (2d Cir. 1943) (contrary to its position in this case, government argued fixed-term contract was goodwill); Rev. Rul. 68-636, 1968-2 C.B. 92 (government reversed its position and conceded that covenents not to compete are not *per se* goodwill).

28 Because of the inconsistencies in the government's legal position, the government's interpretation of section 167 and regulation 1.167(a)-3 is not entitled to deference from this Court. *See, e.g., Fribourg Navigation Co.* v. *Commissioner*, 383 U.S. 272, 279 (1966) ("[t]he Commissioner's position represents a sudden and unwarranted volte-face from a consistent administrative and judicial practice"); *Transco Exploration Co.* v. *Commissioner*, 949 F.2d 837, 840 (5th Cir. 1992) (the Commissioner "ought to do more than stride to the dais and simply argue in the opposite direction").

29 In fact, in *Concord Control, Inc.* v. *Commissioner*, 615 F.2d 1153 (6th Cir. 1980), when the Tax Court found that a business had no goodwill pursuant to that very standard, the government argued on appeal that "the Tax Court committed an error of law by requiring an expectancy of continued customer patronage or competitive advantage . . . to establish the existence of goodwill." *Id.* at 1155.

nected to patronage, but rather, whether the asset is proven to be wasting. This is true with respect to *all* assets. The government's continued reliance on "old customers returning to the old place" simply affords it the opportunity to deny depreciation deductions for certain wasting assets—assets which *must* be depreciated pursuant to section 167 of the Code.

D. The Concept Of Goodwill Must Be Confined To Non-Wasting Assets To Ensure That Income Tax Is A Tax Only On Net Income

The government's position that some wasting assets related to patronage are not depreciable is flatly inconsistent with generally accepted accounting principles. Those principles require that the cost of identifiable assets shall *not* be included in goodwill, but separately accounted for. Accounting Standards, Current Text General Standards ("ASCT") § 160.107 (Financial Accounting Standards Bd. 1991); 1 Accounting Standards Original Pronouncements 467, Accounting Principles Board Opinion No. 17 ("APB Op. No. 17") ¶ 26 (Financial Accounting Standards Bd. 1970). They further require that the costs of identifiable intangible assets be depreciated by systematic charges against income over the periods estimated to be benefited. ASCT at § 160.108.

From an accounting standpoint, therefore, the government's position that identifiable, wasting assets are not depreciable if they relate to patronage results in a clear overstatement of a taxpayer's net income.[30] Disallowing the depreciation of such assets prevents the taxpayer from

30 It is no answer that assets misidentified as goodwill are deductible at the termination or sale of the business. Because of the time value of money, a deduction allowed in the year when the cost is incurred is worth far more than one allowed years later.

To make the point in mathematical terms, the present value of $1 million depreciated over 20 years @10% is $212,839 (assuming a tax rate of 50%). In contrast, the present value of a $1 million deduction that can be taken 20 years later is $74,322—only 35% of the amount depreciated over 20 years. This is precisely why, from an economic standpoint as well as a tax standpoint, each tax year must stand on its own.

deducting costs incurred during certain years to produce income from the income produced during those years. In contrast, allowing the depreciation of identifiable, wasting customer-based intangible assets, such as the subscriber relationships here, furthers the accounting goal of accurately reflecting—and the tax goal of only taxing—net income. *See Northern Natural Gas*, 277 F.2d at 140 (Blackmun, J. concurring) (depreciation deduction for proven wasting asset "seems to me to coincide with good business practice and good accounting."). Petitioner agrees that our tax laws treat goodwill as nonwasting and hence nondepreciable. However, because this principle is contrary to economic and accounting principles, it is especially important that the tax concept of goodwill *not* be expanded to make clearly wasting assets nondepreciable.[31]

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31 Accounting principles hold that goodwill is an intangible asset comprising "the cost of an acquired enterprise over the sum of identifiable net assets." ASCT §§ I60.101, I60.401; APB Op. No. 17 ¶ 1. Its life cannot be estimated reliably either at the date of acquisition or thereafter. APB Op. No. 17 ¶ 16. Assets acquired prior to November 1, 1970 are depreciated as long as they have a determinable life. Assets acquired after that date are depreciated using the best estimation of their useful life, with a maximum life of 40 years to be applied to any asset—*including goodwill*—estimated to have a life longer than 40 years. ASCT §§ I60.102, I60.110. This reflects a 1970 amendment that was based on the conclusion that the value of goodwill almost inevitably becomes zero at some future date. APB Op. No. 17 ¶ 23. The United States General Accounting Office agrees:

> The current tax treatment of goodwill and similar intangible assets fails to recognize the economic benefits that wasting intangible assets contribute over time. These assets are consumed over time even if a precise period cannot be determined. Denying amortization deductions does not result in an accurate determination of taxable income since expenses are not properly matched to income generated.

GAO Report (GAO/GGD-91-88), *Tax Policy: Issues and Policy Proposals Regarding Tax Treatment Of Intangible Assets* (Aug. 1991) at 5.

Citing the necessity of accurately portraying economic reality, the depreciability of goodwill has also been recognized in the federal regulatory context. 17 C.F.R. § 210.9-04 ¶ 14(c); *see also* Staff Accounting Bulletin Nos. 42 & 42A, Fed. Sec. L. Rep. (CCH) ¶ 74,111 at 64,222 (May 3, 1989); *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 15 (1974) ("Although agency-imposed compulsory accounting practices do not necessarily dictate tax consequences [citation omitted], they are not irrelevant and may be accorded some significance.").

E. Ledger Did Not Depreciate Customer-Based Intangibles With Indeterminable Lives Or Non-Ascertainable Values

Consistent with the principle that only intangible assets with determinable lives are depreciable, Ledger did *not* depreciate two of its three basic customer relationships—its advertisers and its newsstand purchasers—because they had no ascertainable lives or values. Those customers differ from Ledger's subscribers in that they must make daily, affirmative decisions to continue patronizing the newspaper.[32] Their values and lives are uncertain and, as such, the advertiser and newsstand purchaser relationships were treated as part of Ledger's nondepreciable $22 million goodwill/going concern value.[33]

As the district court correctly held, the distinction Ledger drew between its depreciable subscriber relationships and its nondepreciable advertiser and newsstand purchaser relationships was correct:

> one must distinguish between a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity and future purchases cannot be predicted, against subscribers who can purchase the same item, for the same price on a daily basis. Although newspaper subscribers are under no legal obligation to

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32 *See Colorado National*, 60 T.C.M. (CCH) at 789 ("The value of the deposit base rests upon the ascertainable probability that inertia will cause depositors to leave their funds on deposit for predictable periods of time.").

33 The government contends that to allow the depreciation of the subscriber relationships here will lead to the depreciation of all types of customer relationships, for "an expert could no doubt be found to conclude that some specific percentage of a particular grocery store's customers" have a determinable life. (Br. U.S. at 11 n.7.) As this case demonstrates, however, not all customer relationships can be shown to have determinable lives *and* values, as were the subscriber relationships here. Even assuming that the government's hypothetical grocery store customers could be shown to have determinable lives, they could not be valued because their purchases—unlike the inertia-based, constant quantity consumption of the subscribers here—will vary constantly. Moreover, the government's argument assumes—incorrectly—that factfinders are incapable of making determinations on ascertainable lives and values. To the contrary, they have been doing so ever since the adoption of the income tax laws, and there is no reason to assume that they cannot continue to do so in the future.

> continue their subscriptions, expert opinion and the evidence presented coupled with common sense and experience leads to the inescapable conclusion that the income derived from such paying subscribers will recur, which, in turn, permits the ascertainment of value separate and apart from goodwill. The income derived from the subscribers permits the calculation of value over the useful lives of the subscriptions or subscribers, and renders the subscribers acquired subject to valuation as an asset separate and apart from goodwill.

(Pet. App. at 32a-33a.)

II.

DISALLOWING THE DEPRECIATION OF AN INTANGIBLE ASSET WITH A DETERMINABLE LIFE AND AN ASCERTAINABLE VALUE WOULD UPSET SETTLED EXPECTATIONS AND RESULT IN THE DIFFERENTIAL TREATMENT OF SIMILARLY SITUATED TAXPAYERS

Taxpayers should be entitled to structure their business transactions based on settled expectations of the tax consequences. *United States* v. *Byrum*, 408 U.S. 125, 134 (1972). Moreover, taxpayers are entitled to expect that the revenue laws be enforced in a uniform fashion. *Portland Golf Club* v. *Commissioner*, 110 S. Ct. 2780, 2789 (1990). The Third Circuit's decision violates both of these principles.

First, the Third Circuit's holding—that some assets with wasting lives and ascertainable values are not depreciable if they are related to future patronage—marks a significant departure from two decades of rulings, which focus on the "economic reality" of the asset and the business. Consistent with section 167, this "economic reality" approach focuses not on an asset's connection to patronage, but on the asset's wasting nature. Thus, taxpayers have had good reason to expect that a customer-based intangible was depreciable if the taxpayer could "show with reasonable accuracy, but without exactitude, the value of the intangible asset and its useful life." *National Service Industries, Inc.* v. *United States*, 379

F. Supp. 831, 833 (N.D. Ga. 1973). The *per se* rule adopted by the Third Circuit is completely at odds with this approach.

Second, the qualifications relied upon by the Third Circuit to limit its aberrational holding—that the subscriber relationships were not embodied in fixed-term contracts and were sold as part of an ongoing business—bear no relationship to whether an asset is wasting. To allow the depreciation of some wasting customer-based assets but deny it for others results in the differential treatment of similarly situated taxpayers.

A. Since At Least 1973, Taxpayers Could Reasonably Expect That Customer-Based Intangible Assets Proven To Have Determinable Lives And Ascertainable Values Would Be Depreciable Under Section 167

Historically, the government has sought to establish that a host of intangible assets connected to patronage were goodwill as a matter of law. *See supra* pp. 27-29. Often, because the taxpayer was unable to meet its burden of demonstrating the asset's determinable life, the government prevailed. *See Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240, 1245-46 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).[34] However, beginning in the 1960's, taxpayers were increasingly able to establish that customer-based intangible assets, in fact, had determinable lives; and though similar assets may have been found nondepreciable in the past, courts permitted their depreciation because taxpayers were able to meet their burden of proof that the asset wasted.[35]

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34 Reviewing prior case law, the court noted that where "the limited and ascertainable lives of the intangibles had been proven by sufficient competent evidence," the taxpayer was allowed to depreciate the customer-based asset. *Id.* at 1249. In contrast, where the taxpayer had failed to carry its burden and did not establish that the asset had a limited life—so that the asset was in the "nature of goodwill"—the asset was held nondepreciable. *Id.*

35 *See, e.g.*, *Super Food Services, Inc.* v. *United States*, 416 F.2d 1236 (7th Cir. 1969) (at-will franchise contracts); *Commissioner* v. *Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966) (at-will loan accounts); *First Pennsylvania Banking & Trust Co.* v. *Commissioner*, 56 T.C. 677 (1971) (at-will depositor contracts).

In the landmark decision of *Houston Chronicle*, the Fifth Circuit expressly held that a subscription list, regardless of its connection to future patronage, was *not* part of the residual goodwill value as a matter of law. *Id.* at 1251.[36] Crystallizing the prior case law, *Houston Chronicle* rejected any suggestion that customer-based intangible assets are *per se* nondepreciable and established a two-pronged test to determine whether an intangible asset may be depreciated. It held that an intangible asset was depreciable if the taxpayer could demonstrate that the asset has (i) an ascertainable value separate and distinct from goodwill; and (ii) a limited useful life, the duration of which can be ascertained with reasonable accuracy. *Id.* at 1251. The *Houston Chronicle* court concluded:

> As the concurring opinion of then-Circuit Judge Blackmun makes clear, if the asset is shown to be a wasting one used in the taxpayer's trade or business, a reasonable deduction must be allowed.

Id. at 1251 (citing *Northern Natural Gas Co.* v. *O'Malley*, 277 F.2d 128, 139-41 (8th Cir. 1960) (Blackmun, J., concurring)).

As a result of *Houston Chronicle*, the IRS conceded that customer-based intangible assets—such as subscription lists, insurance expirations and customer lists—would no longer be treated as *per se* goodwill. Rev. Rul. 74-456, 1974-2 C.B. 65-66. Rather, provided the taxpayer could meet the two-pronged *Houston Chronicle* test, a depreciation deduction would be allowed.[37]

Houston Chronicle marked a turning point in the treatment of customer-based intangible assets. Following the lead of the Fifth Circuit, courts focused on the actual economic characteristics of the asset; if the acquired customer-based intangible asset was proven to have a determinable life and an

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36 Although *Houston Chronicle* did not involve the purchase of an ongoing business, this is not a meaningful distinction. *See infra* pp. 42-44.

37 Nevertheless, the government seized upon the *Houston Chronicle* language "value separate and distinct from goodwill" and argued, inconsistent with its ruling, that customer-based intangibles were not depreciable because they have no value separate and distinct from goodwill. *See supra* p. 28.

ascertainable value, it was depreciable. The anachronistic "old customers returning to the old place" was no longer tolerated as the dispositive litmus test to determine whether an asset should be depreciated. *See, e.g., Houston Chronicle*, 481 F.2d at 1253-54 ("Our view—that amortizability for tax purposes must turn on factual bases—is more in accord with the realities of modern business . . ."); *National Service*, 379 F. Supp. at 834 ("The modern trend of authorities . . . favors the test of 'economic reality' [to determine whether an asset is depreciable]"). So far as Ledger is aware, since *Houston Chronicle*, no court (other than the Third Circuit in this case) has ever held a customer-based intangible asset nondepreciable when a determinable life and ascertainable value were established.

For example, in *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446 (Ct. Cl. 1976), the taxpayer purchased an ongoing insurance business. When the taxpayer sought to depreciate 1,383 insurance expirations (customer information files), the government disallowed the deduction on the ground that the assets were an inextricable part of the business' goodwill. The court held that the proper focus for determining depreciability is not whether the assets technically fall within the amorphous concept of goodwill, but whether the assets, like patents and copyrights and unlike goodwill, have determinable lives and ascertainable values. *Id.* at 452. The court thus found that "[a]n intangible asset is separate and distinct from goodwill when its useful life can be shown with reasonable accuracy to be of limited duration." *Id.* at 454. Accordingly, because the taxpayer proved that the insurance expirations had limited lives of approximately five years (*id.* at 454-56), it was entitled to depreciate those customer-based intangible assets regardless of their connection to future patronage.

In *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987), the taxpayer purchased an ongoing newspaper business and sought to depreciate the newspaper's subscriber relationships. The government disallowed the deduction. At trial, the taxpayer proved that the subscriber relationships had average determinable lives of 23 years. *Id.* at 535. Based on the use of the subscription structure as "an indispensable tool in sell-

ing advertising," the taxpayer also established that the asset's value was derived, in part, from its ability to attract advertising revenues, and not solely from the expectation that it would provide future customers of the business. *Id.* at 536.[38] Accordingly, the Eighth Circuit held that the subscriber relationships acquired by the taxpayer were depreciable intangible assets, and were not goodwill.

In *Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990), the taxpayer acquired nine operating banks. When the taxpayer sought to depreciate the bank's core deposit accounts (customer bank accounts), the government disallowed the deduction. While the government maintained that the core deposit accounts were simply customer relationships, the taxpayer demonstrated that the core deposit accounts had determinable lives and ascertainable values due to their use in the business as a "low-cost source of funds." *Id.* at 489.[39] Thus, the court held that the customer-based intangible assets were depreciable.

In sum, since *Houston Chronicle*, courts have consistently declined the government's repeated invitations to "inquire into the intrinsic nature of the [customer-based] asset measured and determine whether it is, in essence, goodwill." *Col-*

38 The government has tried to distinguish *Donrey* from this case on the ground that "the taxpayer [in *Donrey*] made an effort to identify its written 'subscription list' as an asset separate and apart from its continuing non-contractual relationships with its subscribers." (Br. U.S. at 12.) The government's distinction is incorrect. The taxpayer in *Donrey*, as Ledger sought to do in this case, depreciated the subscriber relationships. In fact, the Tax Court has expressly rejected the government's attempt to recast the depreciated asset in *Donrey* as a subscription list. *See Citizens & Southern Co.* v. *Commissioner*, 91 T.C. 463, 487 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990).

39 The Tax Court subsequently reaffirmed the *Citizens & Southern* holding in *Colorado National Bankshares, Inc.* v. *Commissioner*, 60 T.C.M. 771 (1990), and *IT&S of Iowa, Inc.* v. *Commissioner*, 97 T.C. 496 (1991)—both of which allowed the depreciation of at-will customer-based intangible assets acquired as part of the purchase of an ongoing business. It is well-settled that decisions of the Tax Court should be accorded deference in deciding federal tax cases in recognition of its expertise in the implementation of the income tax laws. *Dobson* v. *Commissioner*, 320 U.S. 489, 502 (1943).

orado National, 60 T.C.M. (CCH) at 789. Instead, recognizing that the most fundamental criterion for a depreciation deduction is whether the asset is wasting, courts have permitted depreciation provided that the taxpayer can demonstrate, as petitioner did here, that the asset is identifiable, has a limited life and is capable of valuation.[40] Whatever "residual" value is left after all identifiable assets, including intangibles with determinable lives, are valued, is goodwill for income tax purposes.[41] As the Tax Court succinctly explained:

> Goodwill, by definition, has an indefinite life, and is valued using the residual method. By contrast, the [customer-based intangible] deposit accounts of the acquired banks could be, and were, identified; had limited lives that could be estimated with reasonable accuracy . . . and could be, and have been, valued directly with a fair degree of accuracy. Moreover, petitioner's deposit accounts were not self-regenerating. [Citation

40 *See generally* cases cited *supra* at pp. 32-38; *see also Los Angeles Central Animal Hospital, Inc.* v. *Commissioner*, 68 T.C. 269 (1977); *Business Service Industries, Inc.* v. *Commissioner*, 51 T.C.M. (CCH) 539 (1986).

41 While the Third Circuit acknowledged that there was substantial case law adopting this view, it erroneously concluded that these cases "represent no more than a minority strand amid the phalanx of cases that have considered the definition and application of the term 'goodwill' in the context of § 1.167(a)-3, and which support the Service's position." (Pet. App. at 23a.) The Third Circuit is wrong. As one commentator observed after exhaustively analyzing the case law:

> Judge Becker's opinion in *Newark* paints a completely misleading picture of the case law, and . . . his statement that the 'overwhelming weight of authority' is with the IRS is only true if one counts the cases without paying any attention to developments over time.

Avi-Yonah, *Newark Morning Ledger: A Threat to the Amortizability of Acquired Intangibles*, 55 Tax Notes 981, 984 (1992).

In fact, the only post-*Houston Chronicle* cases relied upon by the Third Circuit that arguably question the residual approach to goodwill are *General Television, Inc.* v. *United States*, 449 F. Supp. 609 (D. Minn. 1977), *aff'd*, 598 F.2d 1148 (8th Cir. 1979), and *AmSouth Bancorporation and Subsidiaries* v. *United States*, 681 F. Supp. 698 (N.D. Ala. 1988), both of which have been seriously called into question by the subsequent holdings of the Eighth Circuit in *Donrey* and the Eleventh Circuit in *Citizens & Southern*. (*See supra* pp. 35-36.)

omitted]. Therefore, the deposit accounts were assets with values separate and apart from goodwill. It is these characteristics which separate them from general goodwill and permits separate valuations.

Colorado National, 60 T.C.M. (CCH) at 789.[42]

B. Denying The Depreciability Of Wasting Customer-Based Intangible Assets Because They Are At-Will Relationships Or Are Sold As Part Of An Ongoing Business Results In The Differential Tax Treatment Of Similarly Situated Taxpayers

In implementing the tax laws, the government must treat similarly situated taxpayers equally. *See, e.g., Sirbo Holdings, Inc.* v. *Commissioner*, 476 F.2d 981, 987 (2d Cir. 1973); *International Business Machines Corp.* v. *United States*, 343 F.2d 914, 920 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1028 (1966). Notwithstanding this principle, the government seeks to enforce regulation 1.167(a)-3 in a manner that would allow certain taxpayers to depreciate wasting customer-based intangible assets and disallow others the same right based upon two arbitrary distinctions: whether the assets constitute fixed-term or at-will relationships; and whether the assets were acquired separately or as part of an ongoing business. Moreover, the government concedes that certain wasting assets

42 In 1987, a bill was proposed in Congress to amend section 167 and make all customer-based intangible assets nondepreciable. The proposed bill provided, in relevant part:

> *Treatment of Customer Base Intangibles and Similar Items.*—For purposes of determining whether any amount paid or incurred to acquire customer base, market share, or any similar intangible item is allowable as a deduction under this section [167] or any other provision of this title, such amount shall be treated as paid or incurred for intangible property with an indeterminable useful life . . . .

H.R. 3545, 100th Cong., 1st Sess., § 10120 (1987). Thus, the bill would have rendered customer-based intangibles nondepreciable by statutorily bestowing upon them the signal quality that renders goodwill nondepreciable—"an indeterminable useful life." Although the bill was enacted as Title X of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987), Congress declined to adopt the provision denying depreciation of customer-based intangibles. In effect, Congress refused to adopt the position that the government takes here.

used to attract future patronage are depreciable, yet refuses to accord the same treatment to the subscriber relationships here, despite the fact that they are used to attract advertising patronage. None of these distinctions relates to the only relevant inquiry under section 167—whether the assets are wasting—and each is an improper basis upon which to differentiate between taxpayers.

1. The Distinction Between Fixed-Term And At-Will Customer Relationships Improperly Exalts Form Over Substance And Produces Inequality

Although the government at one time maintained that customer relationships embodied in fixed-term contracts constituted goodwill,[43] it now concedes that such patronage is depreciable because of its ascertainable limited life. As the Third Circuit noted in this case:

> the Service does not dispute[ ] that the value of the paid subscribers would not constitute goodwill if Morning Ledger's "expectation of continued patronage" were contractually-based. [citation omitted] Thus, if the subscribers were contractually obligated to continue subscribing for some period of time, Morning Ledger clearly would be permitted to depreciate the value of those contracts over that time period. In such an event, continued patronage would not be a "mere expectation," but a contractual right, and hence not goodwill.

(Pet. App. at 11a-12a.)

Yet patronage stemming from at-will contractual relationships is also more than a "mere expectation" where the taxpayer can identify its customers and prove, as Ledger did, a duration and value for the relationships.[44] Although the use-

43 The government previously claimed that a fixed-term contract represented goodwill because, after the contract expired, the business may well continue to enjoy the benefits of the customer's patronage. *See, e.g., U.S. Industrial Alcohol Co.* v. *Commissioner*, 42 B.T.A. 1323, 1344-45 (1940), *aff'd in part and rev'd in part*, 137 F.2d 511 (2d Cir. 1943).

44 Contrary to the government's suggestion (Br. U.S. at 8 n.6), the subscriber relationships at issue here are contractually-based. When a subscrip-

ful life of a fixed-term customer relationship is expressly stated and the useful life of a terminable-at-will customer relationship is determined by "experience or other factors," regulation 1.167(a)-3 explicitly makes this distinction irrelevant for depreciation purposes. Thus, under § 1.167(a)-3, an at-will customer relationship with a proven, five-year useful life is indistinguishable for depreciation purposes from a customer relationship having a fixed term of five years. Both have a value to the business and will be useful in the business for only five years.

The income tax laws do not exalt form over substance. *See Gregory* v. *Helvering*, 293 U.S. 465, 470 (1935). Applying this principle, this Court held that the same tax treatment must be accorded to a terminable-at-will mining lease and a fixed-term mining lease because the economic realities of the relationship, not the technical form of the lease agreement, properly govern an asset's depreciability under the income tax laws. *United States* v. *Swank*, 451 U.S. 571, 585 (1981). Similarly, prior to the Third Circuit's decision, it was widely accepted that a distinction between fixed-term and at-will customer relationships under section 167 impermissibly exalted form over substance.

In *Super Food Services, Inc.* v. *United States*, 416 F.2d 1236 (7th Cir. 1969), for example, the taxpayer acquired a grocery store chain, including its terminable-at-will franchise contracts. At trial, the taxpayer proved that these customer

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tion is taken, the newspaper agrees to deliver an edition every day and the customer agrees to pay as long as delivery is made. The fact that the customer has the right to cancel the subscription does not make the ongoing relationship non-contractual; until he cancels, the subscriber is contractually obligated to pay. *See, e.g., Landess* v. *Borden, Inc.*, 667 F.2d 628, 631 (7th Cir. 1981) (oral agreements of indefinite duration to collect milk from farmers and deliver it to dairy were implied contracts that were terminable-at-will); *Bell* v. *Speed Queen*, 407 F.2d 1022, 1024 (7th Cir. 1969) (oral agreement for wholesale distributorship franchise that was indefinite as to time and territory was a contract providing continuing performance that was terminable-at-will by either party); *Aaron E. Levine & Co., Inc.* v. *Calkraft Paper Co.*, 429 F. Supp. 1039, 1050 (E.D. Mich. 1976) (oral distributor agreement that contained no express provision regarding duration was a contract terminable at will by either party).

relationships had an average life of seven years. Rejecting the government's attempt to draw a distinction based on the form, rather than the substance, of the relationship, the Seventh Circuit held that:

> neither the statute nor the regulations establish such an inflexible standard. The appropriate test is whether the particular taxpayer has adequately demonstrated that in his business the useful life of the challenged intangibles may be reasonably approximated. [Citations omitted] It is immaterial that the contracts may have no fixed termination date.

Id. at 1240.

Similarly, in *IT&S of Iowa, Inc.* v. *Commissioner*, 97 T.C. 496 (1991), the taxpayer acquired a bank and sought to depreciate the core deposit accounts. As in *Super Food Services*, the government argued that, because the deposit relationships were terminable-at-will, they represented "nothing more than the expected value of future patronage or renewal of previous business, or simply goodwill." The Tax Court flatly rejected the government's argument, holding:

> The fact that a deposit account has no fixed termination date and is terminable at will does not as a matter of law prevent petitioner from factually showing that the deposit base has an ascertainable cost basis separate and distinct from goodwill.

Id. at 509 (quoting *Citizens & Southern*, 91 T.C. at 486).

In essence, the government seeks to establish a new rule that a taxpayer can establish the limited life of a customer-based asset only by embodying it in a fixed-term contract. Such a rule directly conflicts with regulation 1.167(a)-3, which allows a limited life to be established "from experience or other factors," and finds no support in section 167 or—aside from the Third Circuit's decision—the case law. Rather, the income tax laws do *not* exalt form over substance but look to the economic realities of a transaction. Accordingly, until the Third Circuit's decision, depreciation deductions

have been allowed for at-will customer relationships just as they have for fixed-term customer relationships.[45]

2. Whether An Asset Is Sold Separately Or As Part Of An Ongoing Business Has No Bearing On Whether The Asset Is Wasting And Depreciable

In an attempt to distance this case from the holding in *Houston Chronicle*—where a subscription list was found *not* to be goodwill as a matter of law—the government seeks to draw a distinction between a customer-based intangible asset acquired separately and one acquired as part of an ongoing business.[46] According to the government, the former is not *per se* goodwill, the latter is. (Pet. App. at 17a.) Neither the statute nor the Treasury regulations distinguish between assets purchased separately and those acquired as part of an ongoing business.

No court (other than the Third Circuit) has ever denied a depreciation deduction for a wasting intangible asset on the ground that it was acquired as part of an ongoing business. In fact, courts have expressly refused to do so. For example, in *Super Food Services*, the Seventh Circuit stated:

> In our view . . . it is also immaterial whether these [at-will] contracts were acquired separately or as part of a going business. Any quarrel with the going concern value of contracts acquired as part of a business is properly directed to the allocation to be made between goodwill and the contracts purchased and should not be

45 *See, e.g., Donrey*, 809 F.2d at 534; *Super Food Services*, 416 F.2d 1236; *Citizens & Southern*, 91 T.C. 463; *IT&S*, 97 T.C. 496; *Colorado National*, 60 T.C.M. (CCH) 771; *Business Services Industries*, 51 T.C.M. (CCH) 539; *First Pennsylvania*, 56 T.C. 677 (1971).

46 The government's present position—that a subscription list acquired in isolation is *not per se* goodwill—is directly contrary to its position in the *Houston Chronicle* case, where the government vigorously argued that the subscription list's connection to future patronage rendered it goodwill as a matter of law. Moreover, the government's characterization of the asset acquired in *Houston Chronicle* as solely a subscription list is misleading. (Pet. App. at 17a.) In fact, the taxpayer in *Houston Chronicle* acquired a host of intangible and tangible assets, including the seller's goodwill, to which a $775,400 residual value was allocated. 481 F.2d at 1244.

> relied on as requiring a complete denial of depreciation deduction to contracts shown to have a limited useful life.

416 F.2d at 1240.

In *Laird* v. *United States*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978), the taxpayer purchased a professional football franchise and sought to depreciate the players' contracts. As in this case, where the government maintained that the value of the subscriber relationships was inextricably "bound up" with the value of goodwill (Pet. App. at 17a), the government in *Laird* argued that the value of the player contracts was part of an acquired "bundle-of-rights," which could not be disentangled from the business' goodwill value. The Fifth Circuit rejected the government's argument:

> The proposition that the individual assets sought to be amortized have no value except in the context of the entire bundle of rights and assets is at odds with [prior decisions] . . . . It does not matter for purposes of amortization if individual assets only have economic significance in the context of an integrated transaction involving the sale of a number of assets . . . . That the assets contribute value to one another does not prevent their severability for tax purposes.

Id. at 1234; *see also KFOX, Inc.* v. *United States*, 510 F.2d 1365, 1377 (Ct. Cl. 1975) ("[personal] service contracts . . . may be divisible from 'goodwill' and other intangibles and be treated separately for tax purposes."); *Meredith Broadcasting Co.* v. *United States*, 405 F.2d 1214, 1225 (Ct. Cl. 1969) ("the aggregate intangible value of a going business is composed of separate intangible assets which may be separately identified, valued and treated for federal tax purposes, regardless of what terminology [to define goodwill] may be employed.").

In seeking to draw a distinction between assets acquired separately and assets acquired as part of an ongoing business, the government again ignores the purpose of depreciation deductions—to compensate for the wasting nature of certain

assets in order to ensure a tax on net income. In determining whether an asset has a limited life, it is simply irrelevant whether it is sold as part of an ongoing business or sold individually. It is indisputable that a *tangible* asset's depreciability does not turn on whether it was acquired separately or as part of an ongoing business, but rather on whether the tangible asset has a limited life. So too, a customer-based intangible asset does not become nondepreciable because it is sold as part of an ongoing business. As the court in *Super Food* correctly observed, the fact that a customer-based intangible is sold as part of an ongoing business goes only to the "allocation to be made" between the asset and goodwill; it cannot support "a complete denial of depreciation deduction to [at-will] contracts shown to have a limited life." 416 F.2d at 1240. As a result, courts have uniformly allowed the depreciation of customer-based intangibles with limited lives transferred as part of an ongoing business.[47]

3. Many Indisputably Depreciable Intangible Assets Contain An Element Of Continued Patronage

A wasting asset with a determinable life and an ascertainable value is not rendered nondepreciable simply because it contains an element of expected future patronage. *See Richard S. Miller*, 537 F.2d at 450 ("Where the useful life of an intangible readily can be shown to be limited, such as with a patent or a copyright, depreciation is available without question even though for some purposes it is an element of goodwill."); *Colorado National*, 60 T.C.M. at 790 (same). As the government concedes, a fixed-term contract is depreciable even though it may do nothing more than require the buyer to patronize the seller. Subscription lists purchased separately are depreciable, even though they are essentially the right to solicit and receive future patronage from the seller's customers. Even patents, which are cited as an example of depreciable intangible assets under regulation 1.167(a)-3, may

47 *See, e.g., Donrey*, 809 F.2d 534; *Richard S. Miller & Sons*, 537 F.2d 446; *Super Food Services*, 416 F.2d 1236; *Seaboard Finance Company*, 367 F.2d 646; *IT&S*, 97 T.C. 496; *Citizens & Southern*, 91 T.C. 463; *Colorado National*, 60 T.C.M. (CCH) 771; *Los Angeles Central Animal Hospital*, 68 T.C. 269; *First Pennsylvania Banking*, 56 T.C. 677.

amount to little more than the right to receive continued patronage if, for example, the patent holder simply licenses the patent instead of utilizing it himself. In sum, there simply is "no authority for the proposition that assets, intangible or tangible, are not separate and distinct from goodwill unless no part of their value is related to continued patronage of customers of an ongoing business." *Citizens & Southern*, 91 T.C. at 515 (Cohen, J. concurring); *accord Seaboard Finance Company*, 367 F.2d at 651.[48]

III.

THE DEPRECIABILITY OF A WASTING ASSET DOES NOT TURN ON THE METHOD BY WHICH IT IS VALUED

The Third Circuit erroneously held that Ledger's subscriber relationships are *per se* nondepreciable goodwill, and thus did not have to decide which valuation method was appropriate in this case. Nevertheless, it implied that if Ledger valued the intangible assets pursuant to the cost method (the cost of generating similar seasoned subscribers), rather than the income method (the economic benefit to be generated by the subscribers over their remaining useful lives), the assets might have been depreciable. The Third Circuit's apparent rejection of the income method finds no support in the Code, the reg-

48 Even if the embodiment of continued patronage were sufficient to render a wasting asset nondepreciable, the subscriber relationships at issue here would still be depreciable. The subscriber relationships were not valuable solely because of the future subscription fees they would yield. A critical attribute of the subscriber relationships, ignored by the government and the Third Circuit below, is that they are *the* critical asset for generating advertising revenues, and advertising revenues constitute *80%* of the total revenues of the Booth newspapers. (Pet. App. 37a-38a; J.A. at 75, 133, 170-71.) The subscriber relationships were thus valuable not only for the direct patronage that flowed from them, but as an asset used for the attraction of advertisers. *See Donrey*, 809 F.2d at 536. In fact, one of Ledger's experts performed a valuation study of the subscriber relationships taking into account the enhanced advertising revenues and arrived at a value which closely approximated the value ultimately adopted by the district court. (Pet. App. at 46a; J.A. at 160-61.)

ulations, the case law, or commercial practice and should be rejected.[49]

A. The Third Circuit Misconceived The Assets The Taxpayer Sought To Depreciate

The Third Circuit's analysis is muddled by its misperception of the assets that Ledger has sought to depreciate, and upon which the experts offered evidence relating to fair market value. Using the same faulty reasoning applied by the government's discredited experts, the Third Circuit assumed that the assets being valued here—the subscriber relationships—were the same as an asset denominated a "subscription list." The Third Circuit noted with disapproval that Ledger was not "satisfied" to seek a depreciation allowance for its subscription list valued on a cost basis, which the court suggested may have been acceptable. (Pet. App. at 30a.) Although the cost approach might have been an appropriate valuation method for a "subscription list," that fact would determine neither the correct valuation method for the paid subscribers, nor whether the latter assets are depreciable—an issue that turns wholly on whether the subscriber relationships have determinable lives and ascertainable values.

The Third Circuit inaccurately stated that the government "offered expert testimony that the 460,000 subscribers to the Booth newspapers could be valued on a cost basis at roughly $3 million, whereas Morning Ledger's experts valued the same subscribers on an income basis at over $67 million!" (Pet. App. at 29a.) That conclusion is totally at odds with

49 Contrary to the Third Circuit's suggestion that an asset is wholly nondepreciable if the court determines that the allocation between the value of goodwill and an intangible asset is incorrect, courts are required to make the proper allocation in recognition of section 167's command that there be a "reasonable allowance" for depreciation and the fundamental tax principle that an estimated deduction is preferable to no deduction at all. *See, e.g., Seaboard Finance Company*, 367 F.2d at 651; *Cohan* v. *Commissioner*, 39 F.2d 540, 544 (2d Cir. 1930); *Abco Oil Corp.* v. *Commissioner*, 58 T.C.M. (CCH) 1280, 1282 (1990); *Citizens & Southern*, 91 T.C. at 495; *Manhattan Co. of Virginia, Inc.* v. *Commissioner*, 50 T.C. 78, 91 (1968).

every piece of evidence presented at trial and with the uncontested factual findings of the district court.

The government's experts never testified that the 460,000 subscribers acquired by Herald on May 31, 1977, "could be valued on a cost basis at roughly $3 million." Rather, they testified that the *information* contained on a tangible list of the names of those subscribers might be recreated for approximately that amount. (J.A. at 82, 85-86, 175.) Both of the government's experts unequivocally stated that the asset they valued (subscription list) was different from the 460,000 subscriber relationships. (J.A. at 175, 185.)[50] Moreover, both experts conceded that the cost method they used would not properly value the subscriber relationships because it would attribute the greatest value to the least valuable subscriber relationships, and the lowest value to the most valuable relationships—those with "seasoned subscribers." (J.A. at 178-86.)[51] As the district court found, the cost approach did not recognize "the substantial efforts and expenses that had been invested over the years in establishing those [seasoned] subscriber relationships." (Pet. App. at 43a.) Thus, the district court's conclusion that the government's experts "were unqualified, valued the wrong asset and utilized inappropriate methodology" (Pet. App. at 43a) is unassailable.

In sum, Ledger clearly demonstrated that the assets it sought to depreciate—the relationships with the 460,000 sub-

50 The stark difference between the two assets was demonstrated through hypothetical questions posed to one expert which highlighted the difference between the decreased price that would be paid if the list of subscribers were lost on the night before the transaction and the much lower price that would be paid if a catastrophic event annihilated all 460,000 subscribers that same evening. (J.A. at 128-31.)

51 Specifically, under the government experts' methodology, a marginal subscriber would be accorded the highest value based upon solicitation costs because it would require greater effort and inducements to secure his subscription when, in fact, he would be the least valuable subscriber because he would terminate his subscription quickly. By contrast, the seasoned subscriber would be accorded the lowest value based upon solicitation costs because his demand for the paper would be so great that he might subscribe without any solicitation and would not require inducements when, in fact, he would be the most valuable subscriber because he would remain a subscriber for a long period of time.

scribers acquired on May 31, 1977—were distinct from a mere list of subscribers, and it likewise demonstrated that the cost method was not appropriate for valuing the paid subscriber relationships. (Pet. App. at 42a-43a; J.A. at 67, 101, 102-04, 112, 121-23, 162, 165, 175-76.) The question remains, however, whether the use of the income method somehow converted an otherwise depreciable wasting asset into nondepreciable goodwill, as the Third Circuit effectively concluded.

B. The Income Method Was A Proper Method Of Valuation

Intangible assets are *normally* valued pursuant to the income method, for this is the method a willing buyer and willing seller would ordinarily apply in determining the asset's sales price. *See Colorado National*, 60 T.C.M. (CCH) at 792; *see also United States* v. *Ludey*, 274 U.S. 295, 301 (1927). There is no support for the Third Circuit's suggestion that the method of valuing an asset—in particular the use of the income method—is a threshold determinant of depreciability.[52] Many wasting assets, such as patents, are routinely and properly valued by reference to the income, or net economic benefit, they will produce over their limited life, not according to the cost of producing the invention. Where taxpayers have sought to establish the value of a wasting intangible asset pursuant to the income method, courts have consistently allowed such valuations.[53]

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52 Nor do the statute, the regulation, or the government's published revenue rulings provide any support for such a proposition. To the contrary, Congress recently recognized that the income method (or capitalized earnings method) is one of the "commonly accepted methods" of intangible asset valuation for purposes of determining the tax basis of assets in the context of the acquisition of an ongoing business. S. Rep. No. 99-313, 99th Cong. 2nd Sess. 252 (1986).

53 *See, e.g.*, *Donrey*, 809 F.2d 534; *Miami Valley Broadcasting Corp.* v. *United States*, 499 F.2d 677, 689 (Ct. Cl. 1974); *Western Mortgage Corp.* v. *United States*, 308 F. Supp. 333 (C.D. Calif. 1969); *Ithaca Industries, Inc.* v. *Commissioner*, 97 T.C. 253 (1991); *Citizens & Southern*, 91 T.C. 463; *Colorado National*, 60 T.C.M. (CCH) 771; *First Pennsylvania Banking*, 56 T.C. 677; *Manhattan Co. of Va.*, 50 T.C. 78; *Business Service Indus.*, 51 T.C.M. (CCH) 539.

Fundamentally, valuation methodology is an area in which the courts have routinely and properly relied upon experts and those who actually engage in real world transactions between willing buyers and willing sellers. Here, the unequivocal and uncontradicted testimony established, and the district court found, that the income approach "best reflects the method that buyers and sellers would utilize to determine the price at which such assets would change hands." (Pet. App. at 43a-44a.) That testimony and finding in no way undercuts the nature of the assets as having determinable lives and ascertainable values.

In the final analysis, the Third Circuit's conclusion that Ledger had not satisfied its burden of proving a value for its paid subscribers "separate and distinct from goodwill" (Pet. App. at 30a), is simply a restatement of its premise that the value of subscribers is in their continued patronage and, therefore, the subscribers are goodwill which cannot be depreciated. The fallacy in the Third Circuit's reasoning lies in its departure from the fundamental principle that assets with limited lives and ascertainable values are depreciable. The limited lives of the Booth newspapers' subscribers and the fact that they could be directly valued demonstrated conclusively the prerequisites for depreciability; the fact that the valuation method utilized was an income method rather than a cost method in no way detracts from those attributes of the subscribers that make them depreciable.

CONCLUSION

This Court should reverse the judgment below and reaffirm the uniformly accepted principle that an intangible asset that has a determinable useful life and a value distinct from goodwill is depreciable.

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In the Supreme Court of the United States

OCTOBER TERM, 1992

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTION PRESENTED

Whether the purchaser of a newspaper business may treat the continuing patronage of existing customers as an intangible asset that is depreciable under Section 167 of the Internal Revenue Code, 26 U.S.C. 167.

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v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-30a) is reported at 945 F.2d 555. The opinion of the district court (Pet. App. 31a-51a) is reported at 734 F. Supp. 176.

JURISDICTION

The judgment of the court of appeals was entered on September 12, 1991. A petition for rehearing with suggestion for rehearing en banc was denied on October 15, 1991 (Pet. App. 52a-53a). The petition for a writ of

certiorari was filed on January 13, 1992, and was granted on April 6, 1992. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATEMENT

1. In 1976, petitioner's predecessor, the Herald Company (Herald), purchased all the stock of Booth Newspapers, Inc. (Booth). Booth was the publisher of eight newspapers distributed in various Michigan communities. In 1977, Herald liquidated Booth and received all of its assets, including the eight newspaper operations. At the time of Booth's liquidation, those eight newspapers collectively had 460,000 regular subscribers.[1] Herald continued publication of the newspapers under their former banners after Booth was liquidated (Pet. App. 3a-4a, 34a-35a).

Following the liquidation of Booth, under the provisions of Sections 332 and 334(b)(2) of the Internal Revenue Code as then in effect, Herald was required to allocate its basis in the Booth stock (approximately $328 million) among the assets that it received from Booth's liquidation.[2] 26 U.S.C. 332, 334 (1976). In making this allocation, Herald was required to assign basis first to cash, cash equivalents and securities that it received from Booth, then to Booth's tangible and intangible assets (in proportion to their respective fair market values), with the remainder to be allocated to goodwill (Pet. App. 36a). See Treas. Reg. § 1.334-1(c)(4)(viii) (1978); *R.M. Smith, Inc.* v. *Commissioner*, 591 F.2d 248 (3d Cir.), cert. denied, 444 U.S. 828 (1979).

Herald allocated approximately $234 million of its basis in the Booth stock to cash, securities and tangible assets such as the land, buildings and equipment formerly owned by Booth (Pet. App. 36a). Herald then assigned approximately $68 million to an "intangible asset" that it described as "paid subscribers" (*id.* at 4a). This "intangible asset" represented simply the number of ordinary customers who, at the time of Booth's liquidation, subscribed on a daily, at-will basis to one of the Booth newspapers (*id.* at 4a, 12a, 38a-39a). See note 1, *supra*. Herald assigned a value of $68 million to this "intangible asset" under the following rationale: (i) due to factors such as death, relocation, and the mutable nature of consumer preferences, the average person who subscribed to Booth's newspapers on the date of Booth's liquidation would be expected to continue to purchase those newspapers for only a limited number of years, which Herald's experts estimated would vary from 14 to 23 years within the particular communities involved (Pet. App. 5a-6a, 39a); and (ii) during those average periods of continued consumer patronage, the newspapers would receive cumulative revenues from those pre-existing subscribers, net of

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[1] In the courts below, petitioner referred to these customers as "paid subscribers" (Pet. Br. 5; Pet. 4, 6, 7, 8, 9, 10, 15, 26). Any connotation that the subscribers had "paid" for their subscriptions in advance, however, is incorrect. To the contrary, as petitioner now acknowledges (Pet. Br. 4 n.5), these subscribers maintained ordinary daily subscriptions for home delivery that were "terminable at will" (*ibid.*) and subject to immediate cancellation without notice or obligation (Pet. App. 12a, 38a; J.A. 31-32). The only "contractual" (Pet. Br. 4 n.5, 9 n.11, 11-12, 39 n.44) claim that Herald possessed was the right to be paid for newspapers that were delivered: Herald had no contractual or other legal right to insist upon future performance, or demand future custom, from any of its so-called "paid subscribers" (Pet. App. 12a; see note 6, *infra*).

[2] Section 334(b)(2), 26 U.S.C. 334(b)(2) (1976), was repealed by Congress in 1982 and replaced by the somewhat different provisions of Section 338. Under the latter statute, an acquisition of the stock of a target corporation may be treated in certain circumstances as an acquisition of its assets. See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 11.46, at 11-62 (5th ed. 1987). If the assets of a target corporation are simply purchased directly, the taxpayer is also required to allocate the total purchase price among the acquired assets in accordance with their fair market values. See, *e.g.*, *F. & D. Rentals, Inc.* v. *Commissioner*, 365 F.2d 34 (7th Cir. 1966); *Copperhead Coal Co.* v. *Commissioner*, 272 F.2d 45 (6th Cir. 1959).

the costs of collection, equal to the present value sum of approximately $68 million (*id.* at 44a, 46a-47a).[3] Although these customers were free to discontinue their patronage of the newspapers at any time, Herald's valuation rested on the assumption that they would remain customers, and produce revenues for the newspapers, for an average of 14 to 23 years after ownership of the newspapers changed hands. After allocating approximately $68 million of its basis in the Booth stock to the "intangible asset" of its noncontractual relationships with its existing subscribers, Herald allocated the balance of the purchase price that remained (approximately $26 million) to "goodwill" (*id.* at 4a).

2. Section 167(a) of the Internal Revenue Code authorizes, as a deduction for depreciation, "a reasonable allowance for the exhaustion, wear and tear * * * of property used in the trade or business." 26 U.S.C. 167(a). On its income tax returns for periods following the liquidation of Booth, Herald sought to deduct a depreciation allowance with respect to the "intangible asset" it claimed existed in its relationships with its at-will customers. Herald claimed that this "asset" represented "property used in [its] trade or business" (26 U.S.C. 167(a)) that should be depreciated on a straight-line basis over the expected life of those customers' continuing patronage (Pet. App. 4a).

The Internal Revenue Service disallowed the claimed depreciation deductions. Since 1927, Treasury Regulations under Section 167 have consistently provided that "[n]o deduction for depreciation is allowable with respect

[3] In making this calculation, Herald did not reduce the subscription revenues by the costs that it would necessarily incur in producing and delivering the newspaper to its customers (Pet. App. 44a). The only costs deducted by Herald in determining the expected value of its existing relationship with its subscribers were the limited costs involved in collecting the subscription revenues (*ibid.*).

to goodwill." Treas. Reg. § 1.167(a)-3.[4] In the Service's view, the so-called intangible asset of "paid subscribers" (see note 1, *supra*) represents nothing other than the expected income from future patronage of present customers, which is the "goodwill" of the business that Herald purchased from Booth. The Service therefore concluded that Herald was not entitled to a deduction under Section 167.

Herald paid the additional income taxes resulting from disallowance of its claimed deduction for depreciation of its subscribers. When Herald was acquired by and merged into petitioner, petitioner filed administrative claims for refund of the additional taxes that Herald had paid. The Internal Revenue Service did not grant the requested refunds, and petitioner brought this suit in district court (Pet. App. 4a-5a, 33a-35a).

3. Following a bench trial, the district court ruled that the claimed depreciation deductions were allowable in full (Pet. App. 31a-51a). The court acknowledged that "[g]oodwill is conclusively presumed, per se, not to be depreciable" (*id.* at 49a) and that the so-called "paid subscribers" would qualify as a depreciable asset only if they were shown to have (1) a "limited useful life" whose duration could be estimated with reasonable accuracy and (2) "an ascertainable value separate and apart from goodwill" (*ibid.*). The court concluded, however, that petitioner had established that the existing subscriber

[4] Treas. Reg. § 1.167(a)-3 provides:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

relationships had a limited useful life to the business. In reaching this conclusion, the court relied on petitioner's statistical evidence that the subscribers who existed at the time of liquidation would, over a period of years, cease to be subscribers due to death, relocation, loss of interest in the newspapers, or other causes (*id.* at 40a-42a). Although it was not disputed that the total number of petitioner's subscribers in fact remained constant during the years in question (*id.* at 40a; J.A. 94), in the court's view it was "not relevant" that new customers replaced old ones, keeping the newspapers' circulation base intact (Pet. App. 40a).

The district court also concluded that the subscriber relationships had an ascertainable value to the newspaper company of approximately $68 million. That figure was calculated, under the methodology applied by petitioner, by capitalizing the stream of subscription income anticipated from the 460,000 existing subscribers over the average expected duration of their future patronage (Pet. App. 42a-48a).[5]

The district court further concluded that the $68 million attributed to this continuing patronage represented an asset separate and apart from goodwill (Pet. App. 32a-33a, 45a-48a). The court acknowledged that goodwill is the non-contractual expectation that "former customers will be retained—that there will be continued patronage" (*id.* at 32a, 45a). This is often described as "the expectancy that the old customers will resort to the old

[5] In calculating the net income from subscriptions for this purpose, the only costs that petitioner took into account were the relatively nominal ones of billing and collecting the subscription fees. The major costs of publishing and distributing the newspapers were omitted (Pet. App. 6a-7a & n.2, 29a, 44a). See note 3, *supra*.

The government did not attempt to value the stream of income that petitioner would derive from continuing sales of the Booth newspapers to existing subscribers. The government did, however, present evidence that it would cost less than $3 million to mount a circulation drive to develop a comparable number of subscribers (Pet. App. 6a, 29a-30a, 43a; J.A. 79-87).

place" (*ibid.*). In the court's view, however, a business enjoys goodwill only when it has "a galaxy" of anonymous customers "who may or may not return" and whose "future purchases cannot be predicted" (*id.* at 32a). The court stated that the subscribers involved in this case had value and longevity as customers that "can be measured with a fair degree of accuracy" and thus possessed "unique characteristics" separating them from "general goodwill" (*id.* at 45a). The court therefore concluded that petitioner satisfied both elements of the "two-pronged test" for depreciability and upheld petitioner's refund claims (*id.* at 49a).

4. The court of appeals reversed (Pet. App. 1a-30a). The court rejected petitioner's contention that any element of a business that is shown to have a limited useful life is, for that reason alone, distinct from goodwill (*id.* at 12a & n.6). The court noted that it has long been settled that goodwill, which represents the expectancy of continued patronage from existing customers, may not be depreciated (*id.* at 23a-25a). The court regarded it as implicit within the numerous decisions concerning goodwill (and explicit in some of them) that the non-contractual expectancy of future patronage from existing customers may not be written off as an amortizable asset even though such customers are subject to the normal consumer attrition that results from death, relocation, changing tastes, and similar commercial factors (*id.* at 25a-27a, 29a).[6] The court further noted that this con-

[6] The court of appeals observed that this case does not involve "contractually-based" rights (Pet. App. 11a) that would be amortizable under Section 167 (Pet. App. 11a-12a):

> [I]f the subscribers were contractually obligated to continue subscribing for some period of time, [petitioner] clearly would be permitted to depreciate the value of those contracts over that time period. In such an event, continued patronage would not be a mere "expectation," but a contractual right, and hence not goodwill. In the case at bar, however, all the subscribers are

clusion has long been embedded in Treasury Regulations that Congress has not disturbed (*id.* at 28a) and expressed reluctance "to announce a sudden redefinition of a concept so fundamental to tax accounting" (*ibid.*).

The court of appeals concluded that the value that petitioner imputed to its existing subscriber relationships "inherently includes much or all of the value of the expectancy that those customers will continue their patronage" and "is quite clearly comprised largely, if not exclusively, of amounts properly attributable to goodwill" (Pet. App. 30a). Finding that petitioner therefore failed to carry the burden of establishing "a value for its so-called paid subscribers that is separate and distinct from goodwill," the court disallowed petitioner's claimed depreciation deductions (*ibid.*).

The court of appeals acknowledged (Pet. App. 18a-23a) that *Dourey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987) (allowing amortization of newspaper "subscription lists"), and *Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463 (1988), aff'd per curiam, 919 F.2d 1492 (11th Cir. 1990) (allowing amortization of a bank's "core deposits"), seemingly permit taxpayers to amortize "intangible assets" whose value depends on the expected future patronage of existing customers. The court noted, however, that those two decisions represent "no more than a minority strand amid the phalanx of cases" that have interpreted the statute and regulation to proscribe depreciation of such customer-based "intangible assets" (Pet. App. 23a).

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terminable-at-will. At the time of the acquisition of Booth, therefore, Herald merely expected continued patronage; it had no contractual right to demand it.

SUMMARY OF ARGUMENT

Section 167(a) of the Internal Revenue Code authorizes, as a deduction for depreciation, "a reasonable allowance for the exhaustion, wear and tear * * * [and] obsolescence" of property used in a trade or business or held for the production of income. This depreciation allowance is available only for wasting assets whose useful life in a business or other income-producing activity may be predicted with reasonable accuracy. The Treasury regulations under Section 167 therefore provide that "[n]o deduction for depreciation is allowable with respect to goodwill." Treas. Reg. § 1.167(a)-3. The prohibition against the depreciation of goodwill stems from the fact that goodwill inherently fluctuates in value and has an indeterminate useful life. The prohibition was first included in Treasury regulations in 1927. Carried forward essentially unchanged through repeated reenactments of the revenue laws, it has acquired the force of law. See *Cammarano* v. *United States*, 358 U.S. 498, 510 (1959); *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938).

The basic characteristic of goodwill has long been settled. Goodwill consists primarily in the advantage that the proprietor of a business enjoys from the likelihood that existing customers will continue their patronage and will ultimately be replaced by others. Goodwill may be attributable to the location of a business, its age, the quality of its products or services, or any other factor that blesses it with a favorable name and reputation, helping to attract "constant or habitual customers" (*Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436, 446 (1893)). Goodwill is thus ordinarily described as the probability that "the old customers will resort to the old place." *Decker* v. *Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988).

The court of appeals correctly concluded that the $68 million that petitioner assigned as the value of its existing subscriber relationships represents a value that is not distinct from goodwill. These subscribers were non-

contractual, at-will purchasers of the Booth newspapers when Herald took over their publication. The $68 million that petitioner has assigned to these existing customers represents an estimate of the future income to be realized from their continuing patronage. The future income to be derived from the continuing patronage of existing customers is the very core of the concept of goodwill. The value of this future income is not subject to depreciation under the terms of the Treasury's long-standing regulations under Section 167. Treas. Reg. § 1.167(a)-3.

The court of appeals correctly rejected petitioner's argument that its customer relationships may be amortized as separate from goodwill because the subscribers will stop subscribing after a number of years due to death, relocation, loss of interest, or attrition for other reasons. The same is true, and could be estimated by statistical experts, for the customers of any business. Moreover, the very attributes of the Booth newspapers that attracted its subscribers in the first place would be expected to induce (and did induce) new customers to replace them, with the result that the circulation base of the newspapers has remained constant over the years. This ordinary turnover among an established clientele is, of course, a hallmark of the concept of goodwill and explains why goodwill has no determinate useful life even though individual customers are mortal. The value that petitioner attaches to its "old" subscribers is directly subsumed within the established concept of goodwill.

There is no merit to petitioner's claim that the decision of the court of appeals yields unreasonable tax consequences or departs from settled precedent. It is not unreasonable to deny petitioner an annual depreciation deduction for the value of its customer base when both in fact and as a matter of assumed economic behavior, that customer base has not depreciated. To the extent that the customer base of a business fluctuates from year to year, such annual fluctuations in the value of an enterprise are not recognized either as "loss" or as "gain" under the Internal Revenue Code. Moreover, as the court of appeals correctly observed, there is a "phalanx of cases" holding that the future income to be realized from the continued patronage of existing customers represents the very core of the concept of goodwill and is not depreciable under Section 167 of the Code.

ARGUMENT

THE CONTINUED PATRONAGE OF EXISTING SUBSCRIBERS IS NOT DEPRECIABLE UNDER SECTION 167 OF THE INTERNAL REVENUE CODE

A. The Goodwill Of A Business Is Not Subject To An Allowance For Depreciation Under Section 167 Of The Internal Revenue Code

Section 167 of the Internal Revenue Code authorizes as "a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of property used in a trade or business or held for investment. 26 U.S.C. 167(a). This statute permits the cost of depreciable property to be deducted in installments over the taxable periods that such property is expected to be useful in a business. When applicable, the allowance for depreciation promotes the objective of properly reflecting the taxpayer's income for each year, by matching business expenses with the periods in which those expenses aid in the production of income. *Indopco, Inc.* v. *Commissioner*, 112 S. Ct. 1039, 1042-1043 (1992); *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96 (1960). The tax-free recovery of capital through the depreciation allowance is also designed to generate funds for replacement of business property upon its retirement from service. *United States* v. *Ludey*, 274 U.S. 295, 300-301 (1927). See *Fribourg Navigation Co.* v. *Commissioner*, 383 U.S. 272, 276 (1966); *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 101 (1943);

Northern Natural Gas Co. v. *United States*, 470 F.2d 1107, 1109 (8th Cir), cert. denied, 412 U.S. 939 (1973).

An asset may not be depreciated under Section 167 unless it will be consumed through exhaustion, wear and tear, or obsolescence over a period whose duration may be predicted with reasonable accuracy. Assets such as raw land (Treas. Reg. § 1.167(a)-(2)) or an antique violin (*Browning* v. *Commissioner*, 890 F.2d 1084 (9th Cir. 1989)), though useful in producing income, are not eligible for depreciation, for the value of such assets is not normally consumed within a fixed, determinate period. When "no specific * * * useful life can be ascertained" (*Indopco, Inc.* v. *Commissioner*, 112 S. Ct. at 1042) for an asset, its costs are not recoverable through depreciation. The costs of such an asset are instead recovered when the asset is sold, as a deduction from the proceeds of the sale in determining the gain or loss recognized from the transaction. *Ibid.* See also 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 23.2.4, at 23-22 (2d ed. 1989).[7]

Both tangible and intangible assets may be the subject of a depreciation allowance. Because intangible assets are immune from ordinary wear and tear and other forms of physical decay, however, they pose special problems in predicting the date (or the event) of their likely retirement from service. Under long-standing Treasury regulations, an intangible asset may be depreciated if it "is known from experience or other factors to be of use in the business or production of income for only a limited period, the length of which can be estimated with reasonable accuracy." Treas. Reg. § 1.167(a)-3. The specific examples identified in the regulation are copyrights and patents, whose legal life is prescribed by statute.[8] Since

[7] Alternatively, if the asset becomes worthless before it is sold, its owner may recover its basis tax-free by a "loss" deduction under Section 165 of the Code. See 26 U.S.C. 165(a) and (b).

[8] The basis of an acquired contract right may be amortized over the fixed term of the contract if that is an appropriate measure of the asset's economic life. When the contract is predictably subject to renewal, however, the asset has no determinate life and is therefore not subject to amortization. See *McCarthy* v. *United States*, 807 F.2d 1306 (6th Cir. 1986) (franchise agreement); *Miami Valley Broadcasting Corp.* v. *United States*, 499 F.2d 677 (Ct. Cl. 1974) (network affiliation contract); *Meredith Broadcasting Co.* v. *United States*, 405 F.2d 1214 (Ct. Cl. 1968) (FCC license); *Boe* v. *Commissioner*, 307 F.2d 339 (9th Cir. 1962) (medical service contracts); 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 23.2.6, at 23-28 (2d ed. 1989).

its first adoption, however, this regulation has stated unequivocally that "[n]o deduction for depreciation is allowable with respect to goodwill." *Ibid.* Rather than being depreciated, the value of goodwill is added to the capital structure of the business and treated as an offset against the proceeds received when the business is sold. See *Woodward* v. *Commissioner*, 397 U.S. 572, 574-575 (1970).

The premise of the regulatory prohibition against the depreciation of goodwill is that, like stock in a corporation, a work of art, or raw land, goodwill has no determinate useful life of specific duration. While the number of customers of a business (like the value of stock or of raw land) may fluctuate from year to year, those annual fluctuations are not determinate or predictable and are not recognized as either income or loss to the business. The prohibition against the depreciation of goodwill was first included in Treasury Regulations in 1927 (see T.D. 4055, VI-2 C.B. 63, amending Art. 163 of Treas. Regs. 69 (Revenue Act of 1926)). The regulation followed the then-recent decision in *Red Wing Malting Co.* v. *Willcuts*, 15 F.2d 626 (8th Cir. 1926), cert. denied, 273 U.S. 763 (1927), where the court observed that "there can be no wear or tear of good will, or exhaustion thereof" in the sense that would permit a deduction for depreciation (15 F.2d at 633).[9] Subsequent decisions re-

[9] The *Red Wing Malting Co.* case, like many early cases concerning the tax treatment of goodwill, involved the effect of Prohibition on the goodwill of breweries and distilleries. Those cases generated

peatedly have confirmed that goodwill "has no terminable life," but instead "continues in existence just so long as the business continues, and its value fluctuates in direct relationship with the annual variations in the profits of the business" (*Dodge Bros.* v. *United States*, 118 F.2d 95, 100 (4th Cir. 1941)).[10]

The Treasury's determination that goodwill, which fluctuates in value and has no fixed or determinate life, is therefore not subject to depreciation under Section 167, falls well within the scope of the Treasury's interpretive authority. See *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476 (1979) (Treasury regulations that " 'implement the congressional mandate in some reasonable manner,' must be upheld") (quoting *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973) (quoting *United States* v. *Correll*, 389 U.S. 299, 307 (1967))).

a circuit conflict, resolved in *Clarke* v. *Haberle Crystal Springs Brewing Co.*, 280 U.S. 384 (1930), where this Court held that loss of the goodwill of a brewery as a result of Prohibition did not constitute "exhaustion" or "obsolescence" within the meaning of the statutory predecessor of Section 167. See also the companion case of *Renziehausen* v. *Lucas*, 280 U.S. 387 (1930). This Court's holding did not rest on the ground that goodwill is inherently nondepreciable, but rather on a "public policy" ground that Congress did not intend the depreciation statute to compensate for erosion of goodwill suffered by a business closed down as "noxious" under the Constitution (280 U.S. at 386). In *Gambrinus Brewery Co.* v. *Anderson*, 282 U.S. 638 (1931), however, the Court permitted a brewing company to deduct a reasonable allowance for depreciation where Prohibition caused obsolescence of its buildings. The Court explained that the cost of plant depreciation is one of the operating expenses necessary to a manufacturing business and must be taken into account in computing the net income generated by that business over the life of the plant. The Court distinguished *Haberle* and *Renziehausen* because they involved goodwill rather than tangible assets such as plant and equipment (*id.* at 642-643). See also *Burnet* v. *Niagara Falls Brewing Co.*, 282 U.S. 648, 651 (1931).

[10] Decisions with similar holdings are too numerous to cite. Many such decisions, spanning the period from 1927 to present date, are collected at Pet. Br. 24 n.24.

Deference is afforded to the Treasury's interpretations of the tax statutes because (440 U.S. at 477):

> "Congress has delegated to the * * * Commissioner * * *, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 U.S.C. § 7805(a)." *United States* v. *Correll*, 389 U.S. at 307. That delegation helps ensure that in "this area of limitless factual variations," *ibid.*, like cases will be treated alike. It also helps guarantee that the rules will be written by "masters of the subject," *United States* v. *Moore*, 95 U.S. 760, 763 (1878), who will be responsible for putting the rules into effect.

The regulatory treatment of goodwill implements the mandate of Section 167 in a "reasonable" manner by confining the depreciation allowance to assets that, over a foreseeable period, predictably decline in value due to "exhaustion, wear and tear" (26 U.S.C. 167(a)). This central aspect of the regulation has been sustained repeatedly by the courts. Indeed, the nondepreciability of goodwill is "so well settled that the only question litigated in recent years regarding this area of the law is whether a particular asset is 'goodwill.' " *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240, 1247 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974).[11]

The regulatory proscription against the depreciation of goodwill has persisted without material change for 65 years,[12] through frequent reenactments of the tax

[11] See, *e.g.*, *Southern Bancorporation, Inc.* v. *Commissioner*, 847 F.2d 131, 137 (4th Cir. 1988); *Durovic* v. *Commissioner*, 542 F.2d 1328, 1334 (7th Cir. 1976); *Marsh & McLennan, Inc.* v. *Commissioner*, 420 F.2d 667, 669-670 (3d Cir. 1969).

[12] The essence of the restriction against the depreciation of goodwill has been perpetuated in successive versions of the regulation, including the one now in force. See Regulations 77, Art. 203 (Revenue Act of 1932); Regulations 86, Art. 23(*l*)-3 (Revenue Act of 1934); Regulations 94, Art. 23(*l*)-3 (Revenue Act of 1936); Treasury Regulations 103, § 19.23(*l*)-3 (1939 Code). The Treasury

laws.[13] "This case thus comes within the settled principle that 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to * * * have the effect of law.'" *United States* v. *Correll*, 389 U.S. 299, 305-306 (1967) (quoting *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938)).[14]

B. The Expectancy Of Future Patronage From Existing Customers Represents The Core Of The Concept Of Goodwill

The regulation does not itself define goodwill, nor is a definition provided by Section 167. The basic features of goodwill have long been established, however, and were well known before the regulation was first published in

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Regulations under Section 167 have frequently been before the Court. See, *e.g.*, *Fribourg Navigation Co.* v. *Commissioner*, 383 U.S. at 283; *Hertz Corporation* v. *United States*, 364 U.S. 122, 123-124 (1960); *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 98 (1960).

[13] In recent years, bills to codify the regulation or, on the other hand, to relax its limitations by allowing amortization of some "customer-based" assets, have been proposed, but not enacted, as amendments to the Code. See H.R. Rep. No. 391, 100th Cong., 1st Sess. 1058 (1987); H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 937-938 (1987); H.R. Conf. Rep. No. 461, 102d Cong., 2d Sess. 546-547, 564 (1992). During the pendency of this litigation, bills have been introduced in Congress—and may soon be passed—to simplify tax accounting and avoid the barrage of tax disputes recently generated by taxpayers seeking to avoid the substantive distinction between non-depreciable goodwill and other intangible assets. Certain of these proposals would allow ratable amortization of purchased goodwill over relatively lengthy periods of time. See H.R. 11, 102d Cong., 2d Sess. § 4501 (1992) (proposing amortization of purchased goodwill, going-concern value and "customer-based intangibles" over a 14-year period). See also note 29, *infra*.

[14] See also *Cammarano* v. *United States*, 358 U.S. 498, 508-511 (1959); *United States* v. *Leslie Salt Co.*, 350 U.S. 383, 396-397 (1956); *Lykes* v. *United States*, 343 U.S. 118, 127 (1952).

1927. Both historically and currently, the essential characteristic of goodwill is the advantage that the proprietor of a business enjoys from the likelihood that existing customers will continue their patronage. *E.g.*, *Marsh & McLennan, Inc.* v. *Commissioner*, 420 F.2d 667, 669-670 (3d Cir. 1969); J. Story, *Partnerships* § 99 (7th ed. 1881).[15] Near the turn of this century, this Court stated that "goodwill" may be attributable to the location of a business, its age, the quality of its products or services, and any other factor that blesses it with a favorable name and reputation, helping to bring in "constant or habitual customers." *Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436, 446 (1893). The Court later described "goodwill" as "that element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business." *Des Moines Gas Co.* v. *Des Moines*, 238 U.S. 153, 164-165 (1915). See also *Los Angeles Gas Corp.* v. *Railroad Comm'n*, 289 U.S. 287, 313 (1933). Those qualities are widely accepted as the core of the concept of goodwill. See *Black's Law Dictionary* 694 (6th ed. 1991). ("goodwill" is "[t]he favor which the management of a business wins from the public" and is "commonly defined as the expectation of continued public patronage"); 38 Am. Jur. *Good Will* § 1 (1968) ("[t]he narrowest definition" of goodwill is "the probability that the old customers will resort to the old place").

The same understanding of "goodwill" is reflected in the case law interpreting Section 167 and its implement-

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[15] Justice Story's treatise defined goodwill as the "advance or benefit which is acquired by an establishment * * * in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices." J. Story, *supra*, § 99. See also *Hitchman Coal & Coke Co.* v. *Mitchell*, 245 U.S. 229, 252 (1917); *Menendez* v. *Holt*, 128 U.S. 514, 522 (1888).

ing regulations.[16] The prohibition against depreciation of goodwill has produced much litigation, for

> [i]n general, businessmen are opposed to the nondepreciation rule. They would prefer to amortize goodwill fairly rapidly and thereby gain the advantage of substantial annual deductions.

Note, *An Inquiry into the Nature of Goodwill*, 53 Colum. L. Rev. 660, 726-727 (1953). The ordinary commercial impulse to obtain a rapid, tax-free recovery of invested funds has resulted in persistent efforts to obtain depreciation for "customer lists," "subscription lists," "insurance expirations" and other forms of "customer-based intangible assets." A long line of decisions has rejected these efforts (Pet App. 23a-25a (citing cases)) because "customer-based intangible assets" merely recognize the fact that a business has an existing, but not immortal or permanent, clientele. The value assigned to such intangibles thus represents only the goodwill of the business—the "expectancy of continued patronage" from existing customers or the prospect that "old" customers will return to the "old place." As the Third Circuit stated in *Marsh & McLennan, Inc.* v. *Commissioner*, 420 F.2d at 669-670, "[a]ny definition of goodwill includes the concept of the advantage that the proprietor of an existing business enjoys resulting from the probabilities that old customers will continue their patronage." See also *Commissioner* v. *Seaboard Finance Co.*, 367 F.2d 646, 649 (9th Cir. 1966) ("the essence of goodwill is the expectancy of continued patronage, for whatever reason"

[16] This same understanding of the concept of goodwill is also reflected in the legislative history of recent bills dealing with the subject (see note 13, *supra*). See H.R. Rep. No. 391, 100th Cong., 1st Sess. 1058 (1987) (under "[p]resent [l]aw," goodwill "has been defined as the expectancy of continued patronage, for whatever reason, or as the probability that old customers will resort to the old place"); H.R. Conf. Rep. No. 461, 102d Cong., 2d Sess. 546-547, 564 (1992) (goodwill includes "the value of a trade or business that is attributable to the expectancy of continued customer patronage").

(quoting *Boe* v. *Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962)); 5 B. Bittker & L. Lokken, *supra*, ¶ 132.4.5, at 132-73.

Invoking this substantial body of precedent, the court of appeals correctly concluded that goodwill denotes "the expectancy of continued patronage" and "the expectancy that old customers will resort to the old place" (Pet. App. 10a-11a). The court accurately described this definition of goodwill as one that the IRS has consistently applied and that the courts have "overwhelmingly" endorsed (*id.* at 28a).

C. Future Revenues From The Continued Patronage Of Existing Customers Of An Acquired Business Fall Within The Core Of The Concept Of Goodwill

The $68 million value that petitioner has assigned to the "paid subscribers" of the business it acquired, which it seeks to depreciate as a "wasting asset," falls precisely within this established concept of nondepreciable goodwill. This value represents the expected income from the future patronage of the existing customers of the newspaper businesses that petitioner acquired from Booth (Pet. App. 4a, 12a, 38a-39a). The value of such future patronage by existing customers of a business is the essence of the established definition of goodwill.

The customers whose patronage petitioner valued, and sought to depreciate, were those existing at the time that Herald stepped into the shoes of Booth and took over publication of the newspapers as a going concern (Pet. App. 3a-4a, 38a). Petitioner calculated the $68 million value in two basic steps. First, it used statistics to estimate that the existing, at-will subscribers would, on average, continue to subscribe to the Booth newspapers for 14 to 23 years until their patronage was lost due to death, illness, relocation, loss of interest or other commercial reasons (Pet. App. 5a-6a, 39a). Petitioner then calculated the present value of the future revenues (net of collection costs) that it anticipated receiving from those sub-

scribers during the estimated period of their continued patronage (Pet. App. 4a, 6a).[17] The $68 million therefore reflects simply petitioner's estimate of the value of the income it will earn from the continuing patronage of those existing subscribers.

In effect petitioner has appraised—and seeks to shelter from tax through an annual depreciation allowance—the future income that it anticipates receiving from the goodwill of the acquired business. The court of appeals correctly held that this income "inherently includes much or all of the value of the expectancy that those customers will continue their patronage," and therefore "is quite clearly comprised largely, if not exclusively, of amounts properly attributable to goodwill" (Pet. App. 30a). The value of this income forms the very core of the goodwill of the business acquired from Booth, and is thus ineligible for depreciation under the agency's longstanding regulation. Treas. Reg. § 1.167(a)-3. See 1 B. Bittker & L. Lokken, *supra*, ¶ 23.26, at 23-40:

> [L]ists of customers [and] subscription lists * * * are the documentary evidence of the 'customer structure' that is usually regarded as the very core of goodwill.

Except for the fact that the names of specific individuals could not be identified, there is no logical reason to differentiate the persons who regularly (or predictably) purchased newspapers at newsstands or coin boxes from those who had their newspapers delivered at home. Petitioner acknowledges that its "newsstand purchasers" represent one of its "basic customer relationships" (Pet.

[17] Petitioner's calculations were embodied in formal appraisals submitted into evidence (J.A. 52-73). While these appraisals purported to compute the "net" income to be derived from the newspaper subscribers, they failed to account for the actual costs of publishing the newspaper (Pet. App. 6a-7a n.2). One of the appraisers stated that he performed an "alternate" valuation which took publication costs into account and arrived at a value of $61.5 million (*ibid.*; J.A. 160-161). That valuation, as well as its methodology, was not reflected in a written report.

Br. 31). Petitioner also acknowledges that, by contrast with its home delivery customers, its "newsstand purchaser relationships were treated as part of [its] nondepreciable * * * goodwill" (*ibid.*). Petitioner states that it drew this distinction betwen home and newsstand customers because the latter "had no ascertainable lives or values" (*ibid.*).

Petitioner's analysis does not give due credit to the flexibility and inventiveness of expert testimony. It would be within the scope of expertise for a statistician to survey newsstand customers to determine the average regularity and duration of their patronage of a specific newspaper. It would then be within the expertise of an accountant to assign a value to the expected future patronage of these "existing" newsstand customers. A purchase made "once a week" or "twice a week" is as genuine—if less valuable to the business—as one made "once a day." Under petitioner's theory of Section 167, the goodwill of the newspaper thus could be wholly converted into a "wasting intangible asset" by statistical estimates predicting and valuing the expected (or average) custom of its different types of existing customers.

D. The Fact That Existing Customers Will At Some Time Die, Move Away, Or Stop Purchasing Petitioner's Newspapers For Any Variety Of Reasons Does Not Permit Petitioner To Depreciate The Goodwill Of Its Business

Petitioner ultimately concedes that the "tax laws treat goodwill as nonwasting and hence nondepreciable" (Pet. Br. 30). Petitioner contends, however, that the value that it has assigned to its existing subscriber relationships is conceptually distinguishable from goodwill. In petitioner's view, its relationships with existing subscribers had a determinate useful life, for they were destined to end as the subscribers moved away, died, lost interest in the newspapers, or stopped subscribing for any other reason. Because goodwill is normally described as having an indeterminate life, petitioner argues that the income anti-

cipated from the continued patronage of the existing subscribers must derive from something *other* than goodwill. According to petitioner, "[t]he proper inquiry under section 167 is *not* whether the asset is somehow connected to patronage, but rather, whether the asset is proven to be wasting" (Pet. Br. 28-29). This argument was correctly rejected by the court of appeals.

1. The fact that existing subscribers would cease to be subscribers within periods predictable by statistics does not differentiate the value of their continuing patronage from goodwill. As some customers predictably die or move away, others are predictably born (and grow to adulthood) or move in.[18] The very attributes of the newspapers that attracted the "old" customers in the first place help to induce new subscribers to replace them. Petitioner's statistician acknowledged that, notwithstanding the predictable and regular loss of some customers, other new customers appeared, and that the newspapers' overall circulation remained "constant" during the years examined (J.A. 94). He attributed this to a "birth and death process or renewal process" whereby "cancellations" were matched by "additions" (*ibid.*). Because the number of subscribers to the newspapers remained constant, the circulation base had the same value to the business (or to a prospective purchaser of the business) at the end of the taxable periods as at the beginning.[19] Such ordinary turnover, or "ebb and flow," among clientele of

[18] To state an obvious example, children of subscribers, who grow up with the newspaper in their home, may well become subscribers as adults and continue to subscribe long after their parents cease to be subscribers. New community members, who are neighbors of existing subscribers, may be influenced to become subscribers by the newspaper's continuing goodwill.

[19] The size of a newspaper's circulation often affects the rate it can charge for advertising space, which customarily provides the major source of revenue for newspapers (Pet. App. 38a). There is nothing in the record (or in logic) to suggest that the rates paid by advertisers for space in petitioner's newspapers varied as "old" subscribers left and "new" subscribers arrived, so long as the total number of subscribers remained "constant" (J.A. 94).

a business is a standard characteristic of goodwill, and a principal explanation of why a regular allowance for depreciation of "goodwill" is not permitted. See, *e.g.*, *Metropolitan Laundry Co.* v. *United States*, 100 F. Supp. 803, 805 (N.D. Cal. 1951) (gradual replacement of old patrons with new ones left the value of goodwill intact); *AmSouth Bancorporation & Subsidiaries* v. *United States*, 681 F. Supp. 698, 705 (N.D. Ala. 1988) (same).[20]

The loss of old customers and the acquisition of new ones represent offsetting changes in the value of a business that are subsumed directly within the traditional concept of goodwill. The source of petitioner's logical error is its designation of *a particular group* of subscribers as a "wasting asset" in an effort to treat them separately from the valuation of goodwill. Petitioner's effort to carve a depreciable component (existing "subscriber relations") out of a non-depreciable asset (goodwill) has routinely been rejected in analogous contexts. For example, taxpayers who own nondepreciable property (such as land or corporate stock) have sometimes created for themselves an interest in such property for a term of years. The taxpayer is not entitled to amortize this limited property interest because "[d]epreciability cannot be conferred merely by the voluntary, gratuitous division of * * * nondepreciable property into two segments, one of which becomes, as a result of the separation, wasting solely by * * * lapse of time." *United States* v. *Georgia Railroad & Banking Co.*, 348 F.2d 278, 288-289 (5th Cir. 1965), cert. denied, 382 U.S. 973 (1966). Accord, *Lomas Santa Fe, Inc.* v. *Commissioner*, 693 F.2d 71, 72 (9th Cir.

[20] Goodwill is not the only type of asset for which depreciation is not allowed. Whenever an asset is not subject to determinate and regular exhaustion, it is not depreciable under Section 167. See, *e.g.*, *Ithaca Industries, Inc.* v. *Commissioner*, 97 T.C. 253 (1991) (that some employees departed and others were hired did not make work force a depreciable asset), appeal pending, No. 92-1045 (4th Cir.); *Dietz* v. *Commissioner*, 7 B.T.A. 1048, 1050 (1927) (a water well is not depreciable because "like Jacob's well of old, it may last indefinitely").

1982), cert. denied, 460 U.S. 1083 (1983) (land not transformed into depreciable asset by reservation of term for years where taxpayer merely "fragment[ed] its bundle of property rights"); *Farmer* v. *Commissioner*, 1 B.T.A. 711, 711-713 (1925) (same). See generally 5 J. Mertens, *Law of Federal Income Taxation*, § 23A.129 (1992); 1 B. Bittker & L. Lokken, *supra*, ¶ 23.2.5, at 23-33 to 23-34; *id.* ¶ 23.2.6, at 23-43 to 23-44.

This general principle is applicable to this case. The continuing patronage of existing customers of an on-going business forms an integral part of its non-depreciable goodwill. The value of the income to be realized from the future patronage of those customers cannot be made depreciable by "split[ting] its bundle of property rights into two parts" (*United States* v. *Georgia Railroad & Banking Co.*, 348 F.2d at 288). The Code and regulation countenance no such "divide and conquer" approach to goodwill. The subscription income that petitioner expected to earn from the continuing patronage of the existing subscribers is not separable from the goodwill of the newspaper business.

2. Although petitioner's argument is not framed as a direct attack upon the Treasury regulation, acceptance of its position would pave the way for many taxpayers to circumvent the longstanding prohibition against depreciating goodwill. Contrary to petitioner's contention (Br. 31 n.33), its subscribers did not exhibit unique characteristics that set them apart from the customers of other businesses. Almost every commercial establishment or enterprise incurs a regular (and therefore a predictable) turnover among its patrons. These inevitable changes in the customer base of a successful business could be evaluated by the same statistical method used to evaluate the periodic turnover in petitioner's newspaper clientele. For example, an expert could no doubt be found to conclude that some specific percentage of a particular grocery store's customers are "regular customers" who shop at that store each week and who will, for some estimated average length of time, continue to do so until their

patronage is lost owing to death, relocation, or changing consumer preferences. The analysis employed by petitioner, which has attracted the support of amici in diverse lines of business,[21] thus could be used to convert the goodwill of almost any enterprise into a depreciable "intangible asset."

The facts of this case illustrate that acceptance of petitioner's contentions would go far toward "phas[ing] out the concept of goodwill" (*AmSouth Bancorporation & Subsidiaries* v. *United States*, 681 F. Supp. 698, 720 (N.D. Ala. 1988)). In an industry where the expected future patronage of existing customers (or "goodwill") is no doubt financially important, petitioner allocated to goodwill only $22 million of the $328 million that it paid for the stock of Booth (Pet. Br. 4, 31). The methodology employed by petitioner, if pressed to the hilt, would serve equally to eliminate even that $22 million vestige of goodwill. See pages 20-21, *supra*. The court of appeals correctly observed that petitioner's artificial economic analysis improperly converts "much or all of the value" (Pet. App. 30a) of nondepreciable goodwill into a depreciable construct that petitioner once named "paid subscribers" (see note 1, *supra*) and now seeks to describe as existing "subscriber relationships" (Pet. Br. 17).[22]

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[21] See, *e.g.*, Am. Br. of Colorado National Bankshares, Inc., at 7-8; Am. Br. of Charles Schwab Corp., at 2; Am. Br. of Worrell Enterprises, Inc., at 8-9. Taxpayers have long attempted to "whittle down the sphere so that the core of goodwill becomes non-existent." Gregorich, *Amortization Of Intangibles: A Reassessment Of The Tax Treatment Of Purchased Goodwill*, 28 Tax. Law. 251, 270-271 (1975).

[22] Petitioner's reliance on accounting conventions that deal with goodwill (Br. 29-30 & n.31) is similarly misconceived. Accounting principles, which are designed to yield a conservative statement of current income, do not override the explicit directive of the regulations that goodwill is not subject to depreciation under the Internal Revenue Code. See *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 542-543 (1979) (given their different objectives, "any

3. Petitioner errs in asserting that goodwill is merely a "residual" concept under the Internal Revenue Code and has no "fixed content" or "substantive" meaning (Br. 13, 19, 25). The wealth of decisions describing the "substantive" meaning of the concept of goodwill is set out in full in the court of appeals' opinion (Pet. App. 23a-25a). See also pages 16-19, *supra*. Again and again, the case law has stated that the core of the concept of goodwill is the "expectancy of continued patronage" from "old customers * * * resort[ing] to the old place." See, *e.g.*, *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d at 1247 (citing cases). Although petitioner claims that this vast historical basis for the "substantive" meaning of "goodwill" under the Internal Revenue Code represents merely a "shibboleth" (Pet. Br. 26) that, for the better part of a century, courts have unthinkingly "misunderstood" (*ibid.*), petitioner's derogatory description of the case law cannot deprive the word of its accepted meaning. It was with this accepted meaning that the regulation was adopted in 1927, and it is with this accepted meaning that the regulation has since been applied.

Petitioner's claim that goodwill is a "residual" concept (Br. 19 & n.19) is, in any event, based on a misunderstanding of the so-called "residual" method of valuing and allocating basis to purchased intangibles. Under what is now Section 338 of the Code, the residual valuation method is applied when a business favorably positioned in its market is sold at arm's length to a taxpayer who continues to operate it as a going concern. On the assumption that cash and tangible assets are easiest to appraise, their value is deducted from the price paid, leaving the difference as the amount assigned to the intangibles. If the business includes patents, copyrights or similar intangibles that qualify for amortization, their value is also to be determined and subtracted, thereby isolating the "residual" amount attributable to goodwill and going concern

presumptive equivalency between tax and financial accounting would be unacceptable").

value.[23] This method, in somewhat circular fashion, associates with goodwill the "premium" that is paid over and above what other assets of the business would be worth if bought individually. See *R.M. Smith, Inc.* v. *Commissioner*, 69 T.C. 317, 320-323 (1977), aff'd, 591 F.2d 248 (3d Cir. 1979); *Concord Control, Inc.* v. *Commissioner*, 78 T.C. 742, 745-747 (1982); 5 B. Bittker & L. Lokken, *supra*, ¶ 132.4.5, at 132-74 to 132-75.

The residual valuation method was used by the parties in this case in order to narrow their dispute. It was stipulated that $234 million of the $328 million that Herald paid for the stock of Booth was allocable to tangible assets including land, buildings and equipment (Pet. App. 4a,

[23] The fact that "goodwill" has a substantive meaning that distinguishes it from other intangible assets is reflected in the regulations under Sections 338 and 1060 of the Internal Revenue Code, upon which petitioner mistakenly relies (Pet. Br. 19 n.19). These provisions, which were not in force during the years involved in this case, require the buyer and the seller to use the residual method to value assets conveyed in certain transactions. See 26 U.S.C. 338, 1060. A major purpose of this requirement is to promote consistent treatment by parties to the transaction. Previously, the Internal Revenue Service was exposed to a "whipsaw" if the buyer allocated less to goodwill than did the seller. S. Rep. No. 313, 99th Cong., 2d Sess. 251-255 (1986); see *Ullman* v. *Commissioner*, 264 F.2d 305, 308 (2d Cir. 1959).

The regulations under these Sections generally require the purchase price to be allocated first to "Class I assets" ("cash, demand deposits and similar accounts"), then to "Class II asets" (securities, stocks and bonds), then to "Class III assets" (all tangible and intangible assets "other than Class I, II and IV assets"), and then to "Class IV assets" ("goodwill and going concern value"). 26 C.F.R. 1.338(b)-2T(b)(1) and (2); 26 C.F.R. 1.1060-1T(d)(1) and (2). By excepting "Class IV assets" from the definition of "Class III assets," these regulations make clear that goodwill has a separate and distinct substantive meaning, for only those "intangible assets" *that are distinct from "goodwill"* may be valued and assigned a basis under the regulations. Petitioner's unsupported suggestion that the term "goodwill" lacks any substantive content under the "residual" allocation method is thus refuted by the very terms of the regulations on which it relies.

36a-37a). The parties further agreed that the balance of $94 million was allocable *among* goodwill, going concern value, and what petitioner called "paid subscribers" (*ibid.*). Thus, the stage was set for litigation of whether and to what extent the "paid subscribers" were to be assigned a value *distinct from* the going concern value and goodwill of the business. See note 23, *supra*. Use of the residual method helped to frame, but could not answer, that question. Petitioner's argument that goodwill is comprised of what remains after amortizable assets are identified and valued (Br. 19) simply begs the question presented. The residual approach to valuing the assets of a business under Section 338 does not deprive the word "goodwill" of its settled meaning in the regulations under Section 167. See notes 22, 23, *supra*.

4. There is no merit to petitioner's contention (Br. 14-17, 29-30) that denial of its claimed depreciation deduction will prevent proper matching of its revenues and expenses and cause distortion of its true net income. Analogizing its customer base to a wasting, depreciable asset such as a patent or a machine, petitioner suggests that its annual earnings will not be clearly reflected unless the predictable attrition of its old subscribers gives rise to depreciation deductions over the years that the attrition occurs.

These analogies are inapt for several reasons. First, the value to be derived from the future custom, or goodwill, of an enterprise does *not* predictably erode with time: some businesses prosper, others wane; some businesses do both. Under the Internal Revenue Code, the occasion for recognition of changes in the fluctuating value of an investment in an enterprise is at the time of its sale or liquidation, when "gain" or "loss" is recognized (26 U.S.C. 1001(a)). The Code does not require businesses to submit annual appraisals of their fair market value; nor does it seek to tax as income, or allow deductions as a loss for, the annual fluctuations in that value. Just as annual changes in the value of stock or raw land are not

recognized as income or loss under the Code, so too the annual changes in the fair market value of a business are not recognized. Since the value assigned to "goodwill" is associated with the economic "residual" or "excess" value of the enterprise,[24] the unpredictable annual changes in that value cannot support annual "loss" or depreciation deductions.[25]

This does not result in a distortion of petitioner's annual income by failing properly to match its annual expenses with annual income. The annual expenditures made by a business to maintain and promote its goodwill —such as, in the case of petitioner's business, advertising expenses, editorial salaries, and all other ordinary costs of marketing and producing a desirable product— are currently deductible. See 26 U.S.C. 162, 173.[26] The

[24] The economic value of goodwill is often described as the "excess" return derived from the expected continuing patronage of the business's clientele. See, *e.g.*, 5 B. Bittker & L. Lokken, *supra*, ¶ 132.4.5, at 132-74 to 132-75 (the value associated with goodwill is the premium paid over what other assets of the business would be worth if brought individually); Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 Harv. L. Rev. 859, 860 (1968); Note, *An Inquiry into the Nature of Goodwill*, *supra*, 53 Colum. L. Rev. at 712-713.

[25] If petitioner's theory were accepted, and the existing customers of the acquired business were deemed an "intangible asset" subject to depreciation under Section 167, parallel reasoning would suggest that, in the event of early departure of any of the customers, petitioner could deduct the "adjusted basis" allocated to that individual customer as a "loss" under Section 165. See 26 U.S.C. 165. For example, if a machine with a ten-year expected life breaks down after two years and cannot be repaired, the taxpayer could deduct its remaining basis in the machine as a "loss" under Section 165. Treating a departing customer of petitioner's newspaper business as a "loss" is, of course, as absurd as treating a newly arrived customer as a "gain"; but that reasoning is the premise of petitioner's submission.

[26] Section 162 allows a current deduction for "all the ordinary and necessary expenses" (26 U.S.C. 162(a)) of the business that are not subject to capitalization. See *Indopco, Inc.* v. *Commissioner*,

Code does not attempt the impracticable division of these annual, ordinary business expenses into "current" and "capital" components.[27] Since ordinary expenses incurred in maintaining and promoting goodwill are not capitalized, but are currently deducted, allowing petitioner an additional deduction for "depreciation" of goodwill would not yield a proper matching of income and expense: the "double deduction" of maintenance and depreciation expenses claimed by petitioner would occur even though the overall circulation of the newspapers and the economic goodwill of the business remained the same, as new subscribers replaced the old ones (J.A. 94)

112 S. Ct. at 1042-1045. Section 173 specifically permits a current deduction for all costs incurred "to establish, maintain, or increase the circulation of a newspaper, magazine or other periodical." 26 U.S.C. 173(a). This statute originated in the Revenue Act of 1950, ch. 994, § 204(a), 64 Stat. 906. It was enacted to clarify that expenditures to build up the circulation of a publication may be expensed annually, rather than capitalized and depreciated. See S. Rep. No. 2375, 81st Cong., 2d Sess. 63-64 (1950); *Florida Publishing Co.* v. *Commissioner*, 64 T.C. 269, 276-278 (1975), aff'd without opinion, 552 F.2d 367 (5th Cir. 1977). Section 173 excludes from its coverage the costs of acquiring circulation through a purchase of the business of another publisher (26 U.S.C. 173(a)) and thus does not permit petitioner to deduct its investment in the "old" subscriber relationships that it purchased from Booth.

[27] Certain isolated expenditures designed specifically to attract new customers to a business—such as subscription drives—have been held to be subject to capitalization because they aid in the production of income over several years. See, *e.g.*, *Meredith Pub. Co.* v. *Commissioner*, 64 F.2d 890, 891 (8th Cir.), cert. denied, 290 U.S. 646 (1933). Businesses have not, however, been required to allocate ordinary expenses—such as advertising, rent, the cost of maintaining clean or attractive premises or of hiring effective managers and other personnel—into partially-capital and partially-current components, even though goodwill may often or largely be derived from such expenses. See Note, *An Inquiry into the Nature of Goodwill*, *supra*, 53 Colum. L. Rev. at 690. In the case of publishing enterprises, even isolated subscription drive expenses are currently deductible under Section 173. See 26 U.S.C. 173; note 26, *supra*.

and the value of the customers' patronage was thus unaltered (see note 19, *supra*).

If petitioner's depreciation claim were allowed, the costs it associates with purchasing and maintaing its subscriber relationships would be written off and fully recovered—as if they had lost all their value—even though the circulation of its newspapers remained entirely intact. Petitioner understandably seeks to have the best of both worlds: it seeks a current expense deduction for the costs of maintaining and promoting its circulation *and* amortization of its circulation even though it is not declining. Petitioner's claim thus conflicts with the express terms of the regulation and Section 167, which confine depreciation to the predictable loss associated with assets that inevitably wear out over a determinate period. See *Lindheimer* v. *Illinois Bell Tel. Co.*, 292 U.S. 151, 167 (1934) (depreciation represents "the loss, *not restored by current maintenance*, which is due to all the factors causing the ultimate retirement of the property" (emphasis added)).

Although petitioner has not proposed it, there is an alternative, logically consistent method to account for these expenses. Petitioner could be required to *capitalize*, rather than deduct currently, all of the current expenses it incurs to maintain and promote its circulation (as well as the expenses it incurs to purchase circulation from others) and then be allowed to amortize those expenditures over some appropriately lengthy period of estimated benefit. This, however, would require an impracticable division of current expenses (such as editorial and production costs) into partially-current and partially-capital outlays. Congress has specifically elected to avoid that confusing, litigious inquiry. See 26 U.S.C. 173; notes 26, 27, *supra*. Since there is no practicable method to identify and allocate such customer-related costs annually (and there is also no practicable method to appraise the fair market value of businesses annually to determine the actual fluctuations in the economic value of their

goodwill),[28] the practicable solution adopted by the Service under the Code is to permit a current deduction for the ordinary expenses that generally maintain and develop customer patronage (under Section 162) and *not* to permit annual depreciation of goodwill. It is this practicable method that the Code and the regulations under Section 167 adopt for achieving an annual income statement that most "clearly reflect[s] income" (26 U.S.C. 446(b)).[29]

E. The Decision In This Case Comports With Settled Precedent

The court of appeals correctly stated that its decision in this case is in accord with a "phalanx of cases" (Pet. App. 23a) that have rejected similar efforts to depreciate the value that a business associates with the future patronage of its existing customers—the probability that "the old customers will resort to the old place" (*Decker* v. *Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988). Over the long history of the regulation, courts have frequently disallowed amortization deductions to purchasers

[28] See Note, *An Inquiry into the Nature of Goodwill*, *supra*, 53 Colum. L. Rev. at 689 ("even if it were desirable to show present values [of goodwill], to do so would be highly impracticable").

[29] If, as current legislative proposals contemplate (see note 13, *supra*), a business were permitted to amortize purchased goodwill as a wasting, capital asset, the logical corollary would be to require capitalization of the current expenses incurred to develop and maintain that capital asset. See *Indopco, Inc.* v. *Commissioner*, 112 S. Ct. at 1045 (the distinction between ordinary and capital expenses "envisions an inquiry into the duration and extent of the benefits realized by the taxpayer"). Otherwise, the taxpayer would be allowed to recover tax-free all of its investment in an asset that cannot be assumed (and is not shown) to have diminished in value merely by the passage of time. Capitalization of such expenses, however, has not ordinarily been required. See note 27, *supra*. In any event, current legislative proposals have no bearing on the proper disposition of cases to be decided under the existing regulations proscribing depreciation of goodwill.

of customer-based "intangible assets" whose value was tied directly to goodwill, such as customer relationships,[30] distributorships,[31] insurance expirations,[32] and the circulation structure of newspapers and magazines.[33] See 1 B.

[30] See, *e.g.*, *Skilken* v. *Commissioner*, 420 F.2d 266 (6th Cir. 1969); *Golden State Towel & Linen Service, Ltd.* v. *United States*, 373 F.2d 938, 944 (Ct. Cl. 1967); *Commissioner* v. *Seaboard Finance Co.*, 367 F.2d 646, 649-650 (9th Cir. 1966); *Nelson Weaver Realty Co.* v. *Commissioner*, 307 F.2d 897, 901 (5th Cir. 1962); *Boe* v. *Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962); *United States Industrial Alcohol Co.* v. *Helvering*, 137 F.2d 511 (2d Cir. 1943); *AmSouth Bancorporation & Subsidiaries* v. *United States*, 681 F. Supp. 698 (N.D. Ala. 1988); *Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223, 235 (1975); *Credit Bureau of Erie, Inc.* v. *Commissioner*, 54 T.C. 726, 731 (1970).

[31] See, *e.g.*, *Falstaff Beer, Inc.* v. *Commissioner*, 322 F.2d 744, 747-748 (5th Cir. 1963); *J.C. Cornillie Co.* v. *United States*, 298 F. Supp. 887 (D. Mich. 1968).

[32] See, *e.g.*, *Decker* v. *Commissioner*, 864 F.2d 51 (7th Cir. 1988); *Ralph W. Fullerton Co.* v. *United States*, 550 F.2d 548, 550 (9th Cir. 1977); *Marsh & McLennan, Inc.* v. *Commissioner*, 420 F.2d 667, 669-670 (3d Cir. 1969); *Commissioner* v. *Killian*, 314 F.2d 852, 855 (5th Cir. 1963); *Squires* v. *United States*, 289 F. Supp. 597, 600-601 (C.D. Cal. 1968); *Thoms* v. *Commissioner*, 50 T.C. 247, 256 (1968). See also Rev. Rul. 65-175, 1965-2 C.B. 41.

[33] See *National Weeklies, Inc.* v. *Commissioner*, 137 F.2d 39, 42 (8th Cir. 1943) ("[t]he Board [of Tax Appeals] has repeatedly held that a newspaper subscription list is an intangible asset, not ordinarily limited as to time in its use, and so not subject to allowable depreciation for tax purposes"); *Meredith Pub. Co.* v. *Commissioner*, 64 F.2d 890 (8th Cir.), cert. denied, 290 U.S. 646 (1933); *Imperial News Co.* v. *United States*, 576 F. Supp. 865, 867-868 (E.D.N.Y. 1983), aff'd without opinion, 742 F.2d 1434 (2d Cir. 1984); *Toledo Newspaper Co.* v. *Commissioner*, 2 T.C. 794, 809 (1943); *Moon Journal Publishing Co.* v. *Commissioner*, 13 B.T.A. 1379, 1382 (1928); *Danville Press, Inc.* v. *Commissioner*, 1 B.T.A. 1171, 1172 (1925); cf. *Finoli* v. *Commissioner*, 86 T.C. 697, 739 (1986) (CATV subscribers). See also *Strong Pub. Co.* v. *Commissioner*, 56 F.2d 550, 551 (7th Cir. 1932); *Herald-Despatch Co.* v. *Commissioner*, 4 B.T.A. 1096, 1105 (1926); *Gardner Printing Co.* v. *Commissioner*, 4 B.T.A. 37, 39-40 (1926).

Bittker & L. Lokken, *Federal Income Taxation of Income, Estates and Gifts* ¶ 23.2.6, at 23-40 (2d ed. 1989) ("[L]ists of customers [and] subscription lists * * * are the documentary evidence of the 'customer structure' that is usually regarded as the very core of goodwill").

Among the more recent of such cases is *Decker* v. *Commissioner*, 864 F.2d 51 (7th Cir. 1988). In *Decker*, one insurance agency purchased the business and assets of another, including records known as "insurance expirations" that contained information for servicing and soliciting renewals of policies issued to the seller's clients. The buyer took over the seller's business as a going concern, succeeded to its assets, personnel and business location, and intended to use the insurance expirations to maintain the continued patronage of the seller's clients. The court of appeals rejected the buyer's claim to amortize these insurance expirations, for they had no ascertainable value separate from the goodwill of the acquired business. The court observed that goodwill is "the expectancy that 'the old customers will resort to the old place.'" *Id.* at 54 (quoting *Winn-Dixie Montgomery, Inc.* v. *United States*, 444 F.2d 677, 681 (5th Cir. 1971)). In the court's view, it was "irrelevant" whether the taxpayer established a limited useful life for the insurance records based on attrition among the existing customers, for the records were so closely related to the transfer of goodwill that they lacked the status of a discrete amortizable asset. 864 F.2d at 53, 55.

Similarly, in *Boe* v. *Commissioner*, 307 F.2d 339 (9th Cir. 1962), the taxpayers purchased (and thereafter carried on) a medical practice, which included numerous at-will contracts to provide health care services to patients for a fee. The court held that depreciation was not allowed for the value of the contracts in force at the time of the purchase, because that value "depend[ed] entirely upon the expectation that they will not be terminated—that is, the expectancy of continued patronage," which

the court noted was "the essence of good will" (*id.* at 343). The court concluded that the expiration of the existing contracts did not diminish the business in a manner recoverable through depreciation, especially since the business regularly entered into new contracts as the old ones expired, so that the total number outstanding remained the same or even increased during the relevant period. *Id.* at 341, 343.

1. Petitioner nonetheless makes the strained assertion that the decision in this case is "aberrational" (Pet. Br. 33) and disrupts "settled expectations" concerning the tax treatment of such customer-based intangibles (*id.* at 32). In petitioner's view, the "landmark" decision of the Fifth Circuit in *Houston Chronicle Publishing* and subsequent case law support a different result (Pet. Br. 34). That assertion was correctly rejected by the court of appeals.

Houston Chronicle Publishing is distinguishable from this case in all of its important respects. The *Houston Chronicle* was a daily newspaper that purchased the land, equipment, subscription lists and other assets of the *Houston Press*. Unlike the present case, however, the *Chronicle* did not receive the right to use the name or masthead of the *Press* and did not attempt to continue its publication. Instead, after the sale, publication of the *Press* was terminated. 481 F.2d at 1243-1244.

Because there was no intention of continuing publication of the *Press*, the *Chronicle* "did not consider the subscription lists [of the *Press*] to be self-regenerating assets and considered them valuable only to the extent they furnished names and addresses of prospective subscribers." 481 F.2d at 1244. The *Chronicle* estimated that (i) the average cost of obtaining a *new* subscriber was $2 and (ii) the subscription lists could be used in a marketing campaign to obtain 35,600 *new* subscribers for the *Chronicle*. The *Chronicle* therefore estimated that the fair market value of the customer lists it obtained from the *Press* was $71,200, which it sought to amortize over a five-year period. *Id.* at 1243-1244.

Affirming the jury verdict for the *Chronicle*, the Fifth Circuit concluded that the value of subscription lists is amortizable when the "lists are bartered and sold as discrete vendible assets" apart from a going concern. 481 F.2d at 1253. Acknowledging that goodwill represents the "expectancy of continued patronage" (*id.* at 1247), the court correctly held that an intangible asset may be depreciated if it (*id.* at 1250):

> (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy.

This holding does no more than reiterate the clear and specific language of the Treasury Regulation. See 481 F.2d at 1250 (citing Treas. Reg. § 1.167(a)-3).[34]

The description of *Houston Chronicle* as a "landmark" decision stems from petitioner's effort to ignore the *first* factor stressed by that court and emphasize the *second*. The mere fact that a customer-based "intangible asset" can be articulated in a fashion that suggests it has a "limited useful life" is not sufficient for amortization under the regulation *or* under *Houston Chronicle* and the vast "phalanx" of related decisions (Pet. App. 23a). The taxpayer must also show that its customer based "intangible asset" has a value "separate and distinct from goodwill" (481 F.2d at 1250) and thus separate and distinct from the "expectancy of continued patronage" (*id.* at 1247).

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[34] After *Houston Chronicle* was decided, the Service announced that depreciation deductions for customer lists, insurance expirations, and similar "customer-based" intangibles, would be allowed "in an unusual case," where a taxpayer makes a factual showing along the lines of *Houston Chronicle*. Rev. Rul. 74-456, 1974-2 C.B. 65, 66. The revenue ruling cautioned, however, that such assets "[g]enerally" are nondepreciable because they are in the nature of goodwill, representing "the customer structure of a business, their value lasting until an indeterminate time in the future." *Ibid.* This admonition was in effect when Herald liquidated Booth in 1977.

The court of appeals correctly explained why that *first* condition was met in *Houston Chronicle* but is not met in the present case (Pet. App. 17a):

> The *Houston Chronicle* did not purchase an ongoing business or even a tradename as did [petitioner], but rather the idle assets of the defunct *Houston Press*. Hence, there was no "expectancy that old customers would resort to the old place" because "the old place" no longer existed. The value of the customer list to the *Houston Chronicle* therefore lay solely in its potential use as a marketing tool to solicit *new* customers to a *new* business.

Unlike the *Chronicle*, petitioner stepped into the shoes of Booth, kept up the publication of the Booth newspapers under the same banners, and seeks to amortize the estimated value ($68 million) of the future income it expects to derive from the continuing patronage of the Booth subscribers. Petitioner's expert did not appraise the utility of a "subscription list" in canvassing for new subscribers; instead, he appraised the future income to be obtained from the ongoing patronage of existing "subscriber relationship[s]" (J.A. 130-131). Petitioner concedes that there is a "stark difference" in these two concepts (Pet. Br. 47 & n.50). *Houston Chronicle* did not involve the transfer of ongoing customer relationships and provides no support for petitioner's depreciation claim in this case.

Houston Chronicle follows the mold of decisions that allow amortization of acquired customer lists when the buyer did not *also* succeed to the seller's business as a going concern.[35] A taxpayer who acquires a customer

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[35] See, *e.g.*, *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 454, 456-457 (Ct. Cl. 1976) (taxpayer purchased assets of insurance agency, including insurance expirations, but did not use seller's name, location, office procedures or personnel; amortization allowed for value of insurance expirations measured by what it would have cost buyer to solicit and place on its books a comparable amount of new business); *Robins & Weill, Inc.* v. *United States*, 382 F. Supp. 1207 (M.D.N.C. 1974) (taxpayer brought insur-

list without the trade name or work force of the seller cannot rely on the list to effect a transfer of *continuing* patronage or goodwill of the business. In that situation, the customer list provides only a marketing tool, not an assurance or "expectancy" of gaining the custom of the seller's clients.

As the court noted in *General Television, Inc.* v. *United States*, 449 F. Supp. 609 (D. Minn. 1977), aff'd per curiam, 598 F.2d 1148 (8th Cir. 1979), "in the instances in which customer or subscriber lists have been determined to have an ascertainable value separate and apart from goodwill, the lists alone carried with them no expectancy of continued patronage" (449 F. Supp. at 611-612). Accord, *Decker* v. *Commissioner*, 864 F.2d at 55; *Panichi* v. *United States*, 834 F.2d 300, 301-302 (2d Cir. 1987). See note 35, *supra*. The court of appeals correctly emphasized that distinction in this case (Pet. App. 29a-30a):

> Even in those cases where customer lists have been deemed depreciable, the value assigned to the lists

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ance expirations from each of two different agencies, in one case accompanied by a transfer of the seller's name, business location, and staff, but not in the other; the court held that these expirations represented nondepreciable goodwill in the former case, not the latter); *Panichi* v. *United States*, 834 F.2d 300, 302 (2d Cir. 1987) (taxpayer acquired customer list from company in trash collection business, but seller retained trade name and sold most of its route stops to third parties; amortization of customer list was permitted, although court indicated that result would have been different if buyer had purchased "entire business[] as going concern[]" rather than obtaining the list "as an asset separate from a going concern"); *Manhattan Co.* v. *Commissioner*, 50 T.C. 78, 87-88, 93 (1968) (buyer of customer lists did not receive right to use seller's trade name and the lists were "not acquired as a part of a going business"; amortization was allowed to the extent that the lists were valued as "information" that helped the buyer to contact new customers). In *Decker* v. *Commissioner*, 864 F.2d 51, 54-55 (7th Cir. 1988), the court held that a customer list is not depreciable when buyer "step[ped] into the shoes" of seller's insurance agency. The court distinguished *Miller* on its facts because the purpose of the transaction in that case "was not to buy an ongoing business." *Ibid.*

> has been limited to the *cost* of generating a like list of potential subscribers or customers. As a general matter, the courts have not permitted customer lists to be valued as the stream of *income* to be generated by the listed customers over their remaining years of patronage. * * * In this case, the Service offered expert testimony that the 460,000 subscribers to the Booth newspapers could be valued on a cost basis at roughly $3 million, whereas [petitioner's] experts valued the same subscribers on an income basis at over $67 million! More importantly, this difference in the two valuation approaches implicates the central legal dilemma at issue. The fact is that, when employed in the context of the sale of an ongoing concern, the income approach to valuing a list of customers inherently includes much or all of the value of the expectancy that those customers will continue their patronage—i.e., the goodwill of the acquired concern.

See also *Dodge Bros.* v. *United States*, 118 F.2d 95, 101 (4th Cir. 1941) ("A valuation based upon the capitalization of the average of a company's earnings over a number of years smacks peculiarly of a method used in evaluating good will.").

2. a. Although the decisions addressing the depreciation of intangibles are often factually dissimilar, we agree with petitioner (Pet. Br. 35-36) that *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987), bears a close resemblance to this case in several respects. In *Donrey*, the taxpayer bought a newspaper business for $1.3 million. Like Herald, the taxpayer in *Donrey* "stepped into the shoes" of the former owner by continuing to publish the paper under the same name. The taxpayer sought to depreciate a written subscription list (showing the number, names and addresses of subscribers) that it obtained during the purchase of the newspaper as an intangible asset having a limited useful life and a value apart from goodwill. It calculated that figure as "the present value of the difference in advertising reve-

nues generated by the subscription list as compared to the revenues of an equivalent paper without a subscription list." *Id.* at 536. "This value was thus characterized as being separate and apart from goodwill." *Ibid.* In affirming the jury verdict in favor of the taxpayer, a divided panel of the court of appeals concluded that the question whether the subscription list was an asset with a limited life that was separate from goodwill was one of fact for the jury. *Id.* at 536-537.

The issue addressed in *Donrey* is factually distinct from the issue raised in the present case. In *Donrey*, the taxpayer made an effort to identify its written "subscription list" as an asset separate and apart from its continuing non-contractual relationship with its subscribers. Instead of simply calculating the future subscription revenue to be derived directly from those subscribers (as petitioner did in the present case), the taxpayer in *Donrey* computed the additional future advertising revenues that it hoped to obtain by showing its subscription list to potential advertisers. See 809 F.2d at 536.

We disagree with the conclusion of the majority in *Donrey* that this indirect benefit of continuing patronage is separable from the value of goodwill. The taxpayer in *Donrey* succeeded directly to the seller's goodwill in the process of taking over the latter's business as a going concern. The value of the goodwill thus acquired is the benefit derived from the expected future patronage of the customer base of the business. That benefit encompasses both the direct purchases that such customers will make in the future and the indirect advantages of their continuing patronage—such as economies of scale and higher advertising rates—that allow the business to earn a profit on its assets at rates above ordinary returns on invested capital. See note 24, *supra*. Stated more simply, the benefit to the ongoing business is derived not *from the list of customers* but from the continuing patronage that the list symbolizes. As Judge Bright correctly observed in dissent

in *Donrey*, in words equally applicable to this case (809 F.2d at 538-539):

> Of course, the existing subscription list will change from time to time. But, that change does not make the list a depreciable asset.

b. We also agree with petitioner (Pet. Br. 36-38) that *Citizens & Southern Corp.* v. *Commissioner*, 919 F.2d 1492 (11th Cir. 1990), aff'g per curiam 91 T.C. 463 (1988), and *Colorado National Bankshares, Inc.* v. *Commissioner*, 60 T.C.M. (CCH) 771 (1990), appeal pending, No. 91-9019 (10th Cir.), are not consistent with the ordinary rule that "intangible assets" based solely upon the continuing patronage of existing customers are not depreciable. The question in *Citizens & Southern Corp.* was whether the buyer of a bank may amortize the value of the bank's "core deposits," a term defined by the taxpayer to refer to the funds that the bank's customers had on deposit at relatively low rates of interest at the time ownership of the bank changed hands. Such deposits provided a significant source of the bank's income because the bank used them to make loans at higher rates of interest. The Commissioner argued that this "core deposit" intangible represented simply the value associated by the taxpayer with the expectation that existing customers would—due to inertia, convenience or commercial preference—continue their patronage by leaving funds on deposit with the bank for a number of years. The Tax Court, however, permitted the buyer to amortize the value of its "core deposits" as an asset that would "waste" as the existing depositors eventually withdrew those funds from the bank. 91 T.C. at 505-512.[36]

In the present case, the Third Circuit correctly declined to follow *Citizens & Southern Corp.* The court observed that the rationale of *AmSouth Bancorporation & Subsidiaries* v. *United States*, 681 F. Supp. 698 (N.D. Ala.

[36] The Tax Court reached a similar conclusion in *Colorado National Bankshares, Inc.* v. *Commissioner, supra.*

1988), was a more "persuasive and well-articulated" (Pet. App. 27a) analysis of the depreciability of customer-related intangibles such as "core deposits" (681 F. Supp. at 720):

> For accounting purposes, a bank may be able to "identify" a customer deposit base even though it may not be separate and distinct from goodwill. To the extent that deposits remain after some contractually stipulated period, they result from, "continued patronage." The mere fact that the deposits themselves are identifiable, does not make their "*value*" separate and distinct from goodwill. Other facets of bank activities such as safe deposit "expectations," loan "expectations," etc. could perhaps be similarly "identified" so as to phase out the concept of goodwill.

The value of the "core deposits" in *Citizens & Southern* was directly related to the noncontractual proclivity of the "old customers to return to the old place," which is the very essence of goodwill. Nor did the bank's statistical showing concerning the likely duration of their continued patronage suffice to differentiate that value from goodwill. Although individual depositors might come and go, the overall level of deposits was not shown predictably to diminish or waste in the manner required to permit a deduction for depreciation. See 91 T.C. at 521 (Williams, J., dissenting).[37]

Petitioner's assertion that the judgment of the court of appeals in this case disrupts "settled expectations" and

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[37] The Tax Court has declined to extend the approach of the "core deposits" cases to other contexts. In *Ithaca Industries, Inc.* v. *Commissioner*, 97 T.C. 253 (1991), appeal pending, No. 92-1045 (4th Cir.), the court held that a taxpayer who bought a company as a going concern was not entitled to amortize the value it ascribed to the company's existing work force. The court reasoned that the company's personnel did not become a wasting asset merely because some of the existing employees were bound to leave and new ones would be hired in their place. The court explained that "[t]he turnover rate of employees represents merely the ebb and flow of a continuing work force" (97 T.C. at 267).

"marks a significant departure from two decades of rulings" (Br. 32) is demonstrably incorrect. Under established authority of recent as well as older vintage, the settled definition of goodwill is the value associated with the expectancy of continued customer patronage. See, *e.g.*, *Decker* v. *Commissioner*, 864 F.2d at 54; pages 16-19, *supra*. The court of appeals correctly concluded in this case that the few decisions that fail to follow this definition, and that permit amortization of "intangible assets" whose value is premised on expected future patronage from existing noncontractual customers, represent "no more than a minority strand amid the phalanx of cases that have considered the definition and application of the term 'goodwill' in the context of [Treas. Reg.] § 1.167 (a)-3, and which support the Service's position" (Pet. App. 23a).

3. The court of appeals was also correct in rejecting petitioner's claim that amortization should be allowed in this case on the theory that petitioner's "subscriber relationships" are contractual in nature (Pet. App. 11a-12a). Contractual relationships, such as contracts not to compete, or personal service contracts, are subject to amortization because the contract itself specifies that the relationship will last only for a fixed term, thereby establishing its determinate life and wasting character. See 1 B. Bittker & L. Lokken, *supra*, ¶ 23.2.6, at 23-36 to 23-38; but see note 8, *supra*. Goodwill, on the other hand, denotes an expectancy that a customer relationship will continue "without contractual compulsion." *Commissioner* v. *Seaboard Finance Co.*, 367 F.2d 646, 649 (9th Cir. 1966). Accord, *General Television, Inc.* v. *United States*, 449 F. Supp. at 613. The court of appeals cogently explained that distinction as follows (Pet. App. 11a-12a):

> In the case at bar, however, all the subscribers are *terminable-at-will*. At the time of the acquisition of Booth, therefore, Herald merely expected continued patronage; it had no contractual right to demand it.

Contrary to petitioner's arguments (Br. 39-42), its future relationships with its subscribers are not contractually based or defined. The subscribers were merely daily, at-will customers who arranged to have petitioner's newspapers delivered to their homes by mail or carrier, rather than buying the paper at a newsstand or coin box (Pet. App. 38a). Petitioner had no contractual or other right to insist upon future performance or demand any future custom from any of these subscribers (see note 1, *supra*). Petitioner had only an "expectancy" that they would continue to subscribe, and thereby continue to generate subscription revenues for the enterprise, after Herald took over Booth's publishing operations as a going concern. The value that petitioner assigns to the future revenues it anticipates receiving from the continued patronage of existing customers is nondepreciable goodwill.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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No. 91-1135

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE THIRD CIRCUIT

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IN THE

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OCTOBER TERM, 1992

No. 91-1135

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,
Petitioner,

—v.—

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF OF PETITIONER NEWARK MORNING LEDGER CO.

ARGUMENT

The government concedes, as it must, that in order to achieve the proper matching of income and expenses in a particular taxable period, all wasting assets with determinable lives, including intangible assets, are depreciable under section 167 of the Internal Revenue Code ("section 167") and Treasury Regulation 1.167(a)-3 ("regulation 1.167(a)-3"). (Gov't Br. at 11-12.) The government also concedes that goodwill is cast as nondepreciable under regulation 1.167(a)-3 only because "goodwill has no determinate useful life of specific duration." (*Id.* at 13.) Because Ledger proved that the 460,000 specific subscriber relationships purchased as part of the acquisition of the Booth Newspapers have limited useful lives and ascertainable

values, the government's concessions should establish that Ledger is entitled to a depreciation deduction for these assets.

The government nevertheless argues that Ledger is not entitled to depreciate its subscriber relationships because they are the "core" of "goodwill." The government reaches this inconsistent result by arguing that (i) *all* customer relationships (unless embodied in fixed-term contracts) are nondepreciable goodwill, notwithstanding undisturbed findings of fact that the subscriber relationships here lack goodwill's hallmark characteristic of an indeterminable useful life (Gov't Br. at 13-21); and (ii) the customer relationships in *every* business are, like goodwill, a single, self-regenerating asset with an unlimited useful life and a fluctuating value, notwithstanding undisturbed findings of fact to the contrary with respect to the subscriber relationships here. (*Id.* at 21-25.) The first argument rests on the erroneous proposition that an analytically ungrounded *per se* rule—incorrectly equating all patronage with "goodwill"—may override the unequivocal mandate of section 167 that all assets proven to waste *shall* be depreciable. The second argument turns on a mischaracterization of the assets at issue, is flatly contradicted by the record in this case and is nothing less than an attempt—never expressly acknowledged by the government—to resurrect the long discredited and interred *per se* "mass asset" rule.

I.

LEDGER'S WASTING SUBSCRIBER RELATIONSHIPS ARE DEPRECIABLE, AND THE GOVERNMENT OFFERS NO RATIONAL JUSTIFICATION FOR ITS CONTRARY POSITION

A. The Government Concedes That The Only Reason Goodwill Is Nondepreciable Under Regulation 1.167 (a)-3 Is That It Is An Asset With An Indeterminable Life

The government concedes that the defining characteristic of goodwill under the income tax laws is its indeterminable life.

(Gov't Br. at 9, 13-14.) The government also acknowledges that regulation 1.167(a)-3 casts goodwill as nondepreciable precisely because it possesses this defining characteristic. (*Id.* at 13-16.) Indeed, any other reading of the regulation would conflict impermissibly with the plain words of the governing statute—that all wasting assets *shall* be depreciable—and the fundamental matching principles which underlie the entire Internal Revenue Code. In spite of the fact that Ledger's subscriber relationships do not possess goodwill's signature characteristic but instead, as found by the district court, have determinable lives—a finding not disturbed by the Third Circuit on appeal—the government clings to the notion that Ledger's assets are nondepreciable goodwill because they represent patronage, the purported "core" of goodwill. (Gov't Br. at 16-19.)

At the heart of the government's position is the assumption that, based on a myriad of inconsistent, vague descriptions of goodwill, the limitation on depreciating goodwill contained in regulation 1.167(a)-3 is an historically-sanctioned, freestanding prohibition. This assumption is at odds with the government's contrary concession—that the only reason goodwill is cast as nondepreciable under the regulation is that it has an indefinite life; and it is simply wrong. In fact, as Ledger demonstrated in its opening brief, the history of regulation 1.167(a)-3 clearly demonstrates that goodwill was cited as an example of a nondepreciable asset *only* because it has an indeterminable life. (Pet. Br. at 21-24.)[1] Moreover, in contrast with the government's assertion that "the basic features of goodwill

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1 The government is incorrect that the predecessor regulation to regulation 1.167(a)-3 was first promulgated in 1927. (Gov't Br. at 13.) As Ledger previously demonstrated, goodwill was first cast as nondepreciable under the Treasury regulations in 1919 because it was an *example* of an asset that has no determinable life; the regulation was amended to delete this example that same year when the enactment of the Prohibition amendment made it possible for taxpayers to prove that their goodwill had a determinable life; and goodwill was again cast as nondepreciable under the Treasury regulations in 1927 when the Eighth Circuit held that, because goodwill was not subject to wear and tear or exhaustion on the date of purchase, no obsolescence deduction for goodwill was permitted under the predecessor to section 167. (Pet. Br. at 21-24.)

. . . were well known before the regulation was first published" (Gov't Br. at 16), the concept of goodwill has always evaded precise definition, and its contours continue to confound scholars even today. (*See* Pet. Br. at 25-27.) As this Court stated in *Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436 (1893):

> Undoubtedly, good will is in many cases a valuable thing, although there is *difficulty in deciding accurately what is included under the term.*

Id. at 446 (emphasis added).

The government's attempt to portray goodwill as a sacrosanct concept capable of overriding the express mandate of section 167 is unfounded.

B. The Government's Concession That Fixed-Term Customer Relationships Are Not Goodwill Demonstrates The Fundamental Illogic Of Its Position That Ledger's Subscriber Relationships Are Goodwill

The government maintains that customer relationships embodied in written contracts with "specified" terms (Gov't Br. at 43) are depreciable assets, but that Ledger's wasting subscriber relationships are nondepreciable goodwill. The government's unfounded distinction between fixed-term and at-will customer relationships is completely at odds with regulation 1.167(a)-3. That regulation expressly permits the depreciation of all intangible assets where, as here, the taxpayer demonstrates "by experience or other factors" that the assets have determinable lives "which can be estimated with reasonable accuracy." The government's position, therefore, amounts to a naked, impermissible attempt to rewrite regulation 1.167(a)-3—a regulation the government maintains has the "effect of law." (*Id.* at 16.)[2]

2 Contrary to the government's position here, this Court has held that there is no difference between fixed-term contracts and at-will contracts under the Internal Revenue Code because such a distinction would impermissibly exalt form over substance. *See United States* v. *Swank*, 451 U.S. 571 (1981). (*See also* Pet. Br. at 39-42.) Indeed, if the depreciation of customer relationships under section 167 were to turn on whether they are characterized as "contractual" or "noncontractual," as the government urges, resort to the laws of 50 states would be necessary, with its attendant potential for the differential treatment of identical assets. An asset's characterization under state law is not determinative for federal tax purposes; rather, the economic substance of the underlying transaction is controlling. *See Morgan* v. *Commissioner*, 309 U.S. 78, 80-81 (1940) (federal law determines what interests or rights shall be taxed "no matter what name is given to the interest or right by state law"). In any event, under Michigan state law, which would govern the Michigan-based subscriber relationships at issue here, the government's characterization of Ledger's subscriber relationships as "noncontractual" (Gov't Br. at 7 n.6, 9-10) is incorrect. (Pet. Br. at 39 n.44.)

The government's characterization of Ledger's subscriber relationships as goodwill is based on the fact that they represent patronage. However, although "goodwill"—whatever it is—may be *related* to patronage, the government concedes that patronage is *not* synonymous with goodwill under the income tax laws. Indeed, the government admits that customer relationships embodied in fixed-term contracts—pure patronage—are not goodwill for income tax purposes "because the contract itself specifies that the relationship will last for only a fixed term . . . ." (*Id.* at 43.) Moreover, many businesses with continued customer patronage have been found to have *no* goodwill for income tax purposes. (Pet. Br. at 26.)

In sum, the government concedes that customer relationships—patronage—are depreciable if they have determinable lives. Ledger proved by "experience or other factors," and the district court expressly found, that Ledger's subscriber relationships have determinable lives—a finding that the Third Circuit did not disturb on appeal. Accordingly, the government's contention that Ledger's subscriber relationships are not depreciable because they represent patronage is inconsistent with its own regulation and concessions.

C. The Government's Descriptive Approach To Goodwill Yields Inconsistent Results For Similarly Situated Taxpayers

It is not surprising that the government's approach—grounded on a variety of vague and sometimes conflicting

descriptions of goodwill—yields unjustifiable and inconsistent results, for it lacks any analytical rigor for income tax purposes. It provides no useful guidance or workable standards for administering the tax laws. (Pet. Br. at 32-45.) Thus, while the government simply assumes that its various "definitions" of goodwill are clear and interchangeable, they are not.[3]

For example, under one of the government's "definitions," goodwill is "that element of value which inheres in the fixed and favorable consideration of customers . . ." (Gov't Br. at 17)—a description that would include fixed-term customer contracts, which the government concedes are not goodwill. Another "definition" describes goodwill as "the advantage that the proprietor of an existing business enjoys resulting from the probabilities that old customers will continue their patronage" (*id.* at 18)—a description that suggests that goodwill is not the *customers themselves*, but rather something that *attracts* the customers, including such concededly depreciable assets as a patent or an attractive sign. In fact, the inherent problems with employing the government's descriptive approach to depreciation have already become manifest. Although the government asserts that covenants not to compete are paradigms of depreciable assets because they have specified terms (Gov't Br. at 43), the IRS has recently taken the contrary position that these assets may well fall within the core of nondepreciable goodwill. *See* Internal Revenue Service Industry Specialization Program Coordinated Issue Papers, *All Industries, Covenants Not To Compete*, (May 7, 1992), *reprinted in* 95 Daily Tax Rep. (BNA Special Supp.) at S-5 (May 15, 1992).

D. The Method By Which A Taxpayer Values A Wasting Asset Does Not Render The Asset Goodwill

The government also suggests that Ledger's wasting assets are rendered nondepreciable goodwill by virtue of the income method Ledger employed to value the assets. (Gov't Br. at 19-

3 Several amici curiae have pointed out that the government's various "definitions" of goodwill provide them with insufficient guidance as to what types of intangible assets are depreciable. (*See, e.g.*, Black & Decker Corp. Br. at 26-27; Investment Counsel Association of America, Inc. Br. at 8-11.)

21.)[4] This argument, too, is misplaced, for the method by which an asset is valued can never determine whether it is *subject* to a depreciation allowance. (*See* Pet. Br. at 48-49.)[5] Moreover, the government's argument incorrectly assumes that Ledger's subscriber relationships are indistinguishable from all other customer relationships; the government ignores that indefiniteness and uncertainty are the hallmarks of goodwill. As

4 The government alludes to the fact that, in calculating the $68 million fair market value of the subscriber relationships, Ledger did not deduct costs to produce or to distribute the newspaper. (Gov't Br. at 4 n.3, 6 n.5.) The district court correctly found that because production and distribution costs would necessarily be incurred whether the newspapers were free distribution or subscription newspapers, such costs were not attributable to the subscriber relationships. (Pet. App. at 46a.)

Other than questioning these two costs, the government does not take issue with the *amount* Ledger allocated to the subscriber relationships, although it states that the government's alternative valuation method valued the subscriber relationships at $3 million. (Gov't Br. at 6 n.5.) Nevertheless, the factfinder determined that the government's valuation method was entitled to no weight because, among other things, the government's experts valued the *wrong asset* and incorrectly attributed the greatest value to the least valuable subscribers and the least value to the most valuable subscribers. (Pet. Br. at 46-47.)

5 The government also implies that the $68 million Ledger seeks to depreciate—and "shelter from tax"—is simply the future income generated by its subscriber relationships. (Gov't Br. at 20.) This assertion is without merit. The record established that the future income stream of the subscriber relationships is over $384 million (Report of Valuation Engineering Associates, Pl. Ex. No. 1, admitted Tr. at 446; 3rd Cir. J.A. at 909-1009)—income on which Ledger, in fact, pays income tax. In contrast, the income method by which intangible assets are normally valued, and the valuation method Ledger used in this case, assesses the fair market value of assets *on the date of acquisition*. The income method simply reflects the amount a willing buyer would pay a willing seller for an intangible asset at a specific time by calculating the *present value* of the income that the buyer can anticipate receiving from the asset over the determinable life of the asset. In this case, using the income method, the value of the subscriber relationships upon acquisition of the Booth Newspapers was calculated to be $68 million. Thus, Ledger simply seeks to depreciate the value of the assets over their determined lives. If Ledger had acquired a patent—an indisputably depreciable intangible asset—as part of the Booth transaction, it would pay income tax on the revenues the patent generates over time *and* depreciate the present value of those revenues at the time of acquisition—the "fair market value" of the patent—over the determinable life of the patent.

expressly allowed by regulation 1.167(a)-3, Ledger proved—and the district court found—that there is no uncertainty associated with the subscriber relationships at issue in this case. Unlike the government's hypothetical grocery store customers, Ledger's subscribers are not "ordinary customers" (Gov't Br. at 3)—customers who must make daily affirmative decisions to continue patronizing the business—and the value of the subscriber relationships "does not depend upon a vague hope" that they will continue to purchase newspapers. *See Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463, 499 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990); *Colorado National Bankshares, Inc.* v. *Commissioner*, 60 T.C.M. (CCH) 771, 789 (1990), *appeal docketed*, No. 91-9019 (10th Cir. Oct. 3, 1991). Rather, in contrast to anonymous grocery store customers who have unpredictable buying habits and indeterminable lives, the value of Ledger's subscriber relationships here is ascertainable based on the quantifiable, regular purchases (at fixed prices) the subscribers will make over the proven future periods the relationship will last. (*See also infra* at 11-12, discussing the difference between Ledger's 460,000 individual subscriber relationships and a mass customer base.)[6]

6 The government's argument that experts can establish a predictable life and value for any customer relationship is premised on an unfounded distrust of factfinders. (Gov't Br. at 21, 24.) The government's cynicism concerning expert testimony is belied by the facts in this case. Ledger's experts were unable to make such determinations concerning the lives or values of the newspapers' newsstand customer relationships or advertising customer relationships. (Pet. Br. at 31 n.33.) Similarly, amicus curiae Coopers and Lybrand, a national accounting and consulting firm that is regularly engaged as an expert to ascertain assets' lives and values, has stated that it is *not* capable of predicting a life and value for all customer relationships. (Coopers & Lybrand Br. at 11.)

The government's argument also questions the appropriateness of one of the most fundamental tenets of American jurisprudence—the exclusive province of factfinders to assess the credibility of witnesses, to weigh the evidence presented and to render factual findings. These firmly-rooted principles have always been given full force in tax cases. Indeed, in order to implement the fundamental matching principles of the Internal Revenue Code, factual inquiries, and not *per se* rules, are essential. *See Tank Truck Rentals, Inc.* v. *Commissioner*, 356 U.S. 30, 35 (1958) (fact-based inquiries are necessary "to accommodate . . . the congressional intent to tax only net income").

E. The Government's *Per Se* Rule Equating Patronage With Goodwill Conflicts With Settled Precedent

The government maintains that taxpayers have been permitted to depreciate customer-based intangible assets in only a minority of cases, and that the Third Circuit's decision here—adopting the government's unanalytical descriptive approach to depreciation—comports with "settled precedent." (Gov't Br. at 32-43.) However, since at least the Fifth Circuit's decision in *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), the trend of the law has been that the depreciation of customer-based intangibles turns on factual inquiries and not *per se* rules. (Pet. Br. at 32-44.) The Third Circuit's decision is thus an aberration. In fact, after the *Houston Chronicle* decision, even the IRS ruled that it would abandon the *per se* approach the government now urges this Court to adopt. *See* Rev. Rul. 74-456, 1974-2 C.B. 65.

Even the few post-*Houston Chronicle* cases cited by the government do not support its current position that all patronage-related assets are *per se* nondepreciable goodwill. Instead, where depreciation deductions were denied, it was because the taxpayers failed to satisfy the factfinder that the assets at issue had limited lives and/or ascertainable values.[7] Indeed, in one case cited by the government, the court correctly held that a depreciation deduction in some amount *must* be allowed where, as here, the taxpayer had proven that the assets had limited lives and ascertainable values. *See Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223, 235 (1975), *acq.*, 65 T.C. 1153 (1976).

The government's discussion of *Houston Chronicle* also highlights the fundamental flaws in the government's argu-

7 Although the two-part depreciation test adopted by the Fifth Circuit in *Houston Chronicle* speaks in terms of "value separate and distinct from goodwill," in fact, consistent with section 167 and regulation 1.167(a)-3, *Houston Chronicle* held, as courts repeatedly have since held, that an asset is "separate and distinct" from goodwill if it is proven to lack goodwill's defining characteristics—an unlimited life and an unascertainable value. 481 F.2d at 1249. (*See also* Pet. Br. at 33-38.)

ment. (Gov't Br. at 35-37.) First, the government erroneously suggests that the only reason the taxpayer in *Houston Chronicle* was able to prove that the value of its customer-based asset was "separate and distinct from goodwill" was because, as the asset was not acquired as part of an ongoing business, no goodwill was acquired in the transaction. (Gov't Br. at 36-37.) Although the taxpayer in *Houston Chronicle* did not acquire an ongoing business, it did, in fact, acquire goodwill in the transaction and thus, like Ledger here, allocated separate values to customer-based intangibles and goodwill and proved that its allocation between the two was reasonable. 481 F.2d at 1244. Second, the government emphatically states that "the mere fact that a customer-based 'intangible asset' . . . has a 'limited useful life' is not sufficient for amortization under the regulation *or* under *Houston Chronicle* . . . ." (Gov't Br. at 36.) However, if *Houston Chronicle* were construed as the government argues, it would conflict impermissibly with section 167 and regulation 1.167(a)-3. *See Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 341 (1979) ("the language of an opinion is not always to be parsed as though we were dealing with language of a statute"). (*See also supra* at 2-5.)

II.

LEDGER'S SUBSCRIBER RELATIONSHIPS ARE NOT SELF-REGENERATING

Ignoring the record and the undisturbed findings of fact, the government maintains that what is really at issue in this case is not 460,000 *individual* subscriber relationships purchased at a specific point in time, but rather, a "circulation base"—a single asset which, like goodwill, self-regenerates (*i.e.*, as one customer is lost, another customer "appear[s]") and, as such, has an indeterminable life and an immeasurable value. (Gov't Br. at 22-24.) The district court, however, expressly found that Ledger's subscriber relationships are *not* a mass circulation base and are *not* self-regenerating (Pet. App. at 40a), and the Third Circuit did not disturb these findings on appeal. (*Id.* at 14a, 16a.)

While carefully avoiding the label, the government essentially urges this Court to resurrect the long-discredited "mass asset" doctrine—a *per se* rule which presumes that all customer-based assets are self-regenerating and thus, nondepreciable goodwill. (*See id.* at 14a.) Regardless how the government may now articulate its position, application of a *per se* self-regeneration rule to deny depreciation deductions for wasting customer-based intangible assets has been repeatedly rejected because it violates the mandate of section 167 and exalts *per se* rules over proven economic reality:

> Without compiling the myriad cases that discuss the "mass asset" rule, we are satisfied that the rule does not establish a *per se* rule of non-amortizability in every case involving both goodwill and other intangible assets. *** We reject . . . a monolithic "mass asset" theory that would amalgamate all subscription lists with goodwill. *** Our view—that amortizability for tax purposes must turn on factual bases—is more in accord with the realities of modern business . . . .

Houston Chronicle Publishing Co. v. *United States*, 481 F.2d 1240, 1249-50, 1253 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).[8] Indeed, even the Third Circuit in this case recognized that the mass asset doctrine is "a sort of legal fiction" that is "now outdated." (Pet. App. at 14a.)

A. The Facts In This Case Demonstrate That Ledger Does Not Seek To Depreciate A "Circulation Base"

The facts in this case demonstrate why blind application of the government's mass asset/self-regeneration fiction is no

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8 In fact, the IRS purported to abandon the mass asset rule subsequent to the *Houston Chronicle* holding. Rev. Rul. 74-456, 1974-2 C.B. 65; *see also Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463, 482 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) ("it appears that [the Commissioner] is urging us to apply the 'mass asset' rule although he does not articulate his position as such"; court rejected argument that customer-based intangibles are "as a matter of law the equivalent of goodwill and, therefore, nondepreciable"); *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 452 (Ct. Cl. 1976) (rejecting the mass asset rule, the court held that "[e]ntitlement to a depreciation allowance is a question of fact and not of law").

longer tolerated and is inappropriate here. The record is clear that, in evaluating the fair market value of the assets of the Booth Newspapers, Ledger valued the 460,000 distinct subscriber relationships in existence at the time it acquired the Booth Newspapers—*not* an amorphous "circulation base." (*See* J.A. at 110, 130-31, 166, 168-69, 170-71.) Indeed, Ledger knew these subscribers' names, addresses and demographic characteristics. (*Id.* at 168-69.) Consequently, Ledger was able to value these specific relationships based on the quantifiable purchases at determinable prices to be made by the subscribers for the predictable future periods the relationships would last. (*Id.* at 53-73.)

In short, there is no evidence to support the government's position that Ledger valued—and now seeks to depreciate—a single mass circulation base that includes subscribers Ledger might acquire in the future, rather than the 460,000 individual subscriber relationships which the seller actually delivered to Herald upon acquisition of the Booth Newspapers. *See Citizens & Southern*, 91 T.C. at 499, *aff'd upon the opinion below*, 919 F.2d 1492 (11th Cir. 1990) ("The new accounts which were opened subsequent to the acquisitions are not in dispute"); *Super Food Services, Inc.* v. *United States*, 416 F.2d 1236, 1239 (7th Cir. 1969) ("Even if we were to find the indivisible [mass] asset doctrine sound in theory, we would have no occasion to apply it to facts such as those presently before us where the taxpayer has made a reasonable showing that the [at-will] contracts were valued individually at the time of the purchase decision."); *Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223, 236 (1975), *acq.*, 65 T.C. 1153 (1976) (the government's self-regeneration "argument, however, ignores the fact that the issue here deals only with the credit information purchased from [the sellers]. The newly recorded information is not in dispute").[9]

9 The government also suggests that customer-based intangibles, such as those at issue here, are an inextricable component of nondepreciable goodwill, and the "Code and regulations countenance no such 'divide and conquer' approach to goodwill." (Gov't Br. at 23-24.) The government's argument, however, finds no support in the Code, in the Treasury regulations or in the case law. The "analogous" authority cited by the government is plainly inapposite. (*Id.*) The cited cases stand for the proposition that a taxpayer may not transfer to itself a remainder interest in a non-wasting asset (such as land) in order to establish a limited useful life. The consistent rationale for denying depreciation in those cases is that the taxpayer had not acquired anything it had not owned previously and had not incurred additional cost with respect to the retained interest. Accordingly, denying depreciation deductions to these taxpayers correctly implemented the fundamental principles of the Code by: (i) refusing to exalt the asset's form over the substance of the transaction; and (ii) ensuring that the taxpayer, who acquired the "asset" from itself, properly matched expenses with earnings. In contrast, courts have uniformly rejected the government's "bundle of rights" theory where taxpayers have satisfied the factfinder, as Ledger did here, that their customer-based intangible assets, acquired in an arm's length transaction, are truly wasting. *See, e.g., Laird* v. *United States*, 556 F.2d 1224, 1234 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978); *KFOX, Inc.* v. *United States*, 510 F.2d 1365, 1377-78 (Ct. Cl. 1975); *Meredith Broadcasting Co.* v. *United States*, 405 F.2d 1214, 1225 (Ct. Cl. 1968). (*See generally* Pet. Br. at 33-45.)

B. The Facts In This Case Demonstrate That Ledger's Subscriber Relationships Are Not Self-Regenerating

More importantly, while the government claims that customer self-regeneration is a "standard characteristic" of goodwill (Gov't Br. at 23), there is no evidence to support the government's assertion that Ledger's subscriber relationships are "self-regenerating." Indeed, the district court expressly found that "the paid subscribers of the Booth newspapers as of May 31, 1977, were *not* self-regenerating" (Pet. App. at 40a (emphasis added)) and the overwhelming evidence supported this finding. At the time of the acquisition, Ledger knew that the purchased subscriber relationships would eventually terminate and that it would have to expend substantial efforts and resources to secure new subscribers to replace those that it would inevitably lose. (*See* Pet. App. at 40a; J.A. at 76-78, 112-13, 145-46, 166-67.) In fact, whether Ledger could secure new subscribers was by no means certain because the entire newspaper industry was having considerable difficulty acquiring new subscribers to replace lost ones. (*See* J.A. at 76-78, 139-43, 147, 146-50.)[10] The reasons were numerous and varied,

10 The Report of Urban & Associates, Inc. (Pl. Ex. No. 4, admitted Tr. at 202; 3rd Cir. J.A. at 1115-50) explained the significant difficulty faced by

including competition from other media sources, a worsening economy, and cultural and demographic shifts. (*See* Pet. App. at 40a-41a; Tr. at 205-06, 210, 227-38.) Because the Booth Newspapers are located in Michigan, troubles in the automobile industry would particularly impact Booth's readership. (*See* J.A. at 146.) Moreover, contrary to the government's suggestion (Gov't Br. at 22 n.18), Ledger could not assume that children would automatically replace their parents as subscribers, for newspaper readership among younger generations was on the decline. (*See* Tr. at 228.)

Ledger's proof that it would have to make sizeable efforts to obtain new subscriber relationships as old subscriber relationships ended further demonstrates that the assets are neither *self*-regenerating nor part of Ledger's goodwill. *See, e.g., McCarthy* v. *United States*, 807 F.2d 1306, 1313 (6th Cir. 1986) (intangible assets held not self-regenerating where "the franchise must invest additional capital to retain the asset"); *Super Food Services*, 416 F.2d at 1239 ("When, for example, through the pressure of local competition, ill health, or dissatisfaction with the services provided under the contract, a franchisee terminates his relationship with the taxpayer . . . the value of the purchased business is diminished. Only through taxpayer's own efforts . . . will that value be restored."); *Colorado National Bankshares*, 60 T.C.M. (CCH) at 789 ("petitioner's deposit accounts were not self-regenerating . . . [t]herefore, the deposit accounts were assets with values separate and apart from goodwill").

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newspapers in obtaining new subscribers, and described the declining overall market penetration that newspapers, including the Booth Newspapers, were experiencing. This report demonstrated that not only were all of the Booth Newspapers losing market penetration but also that five of the eight newspapers had suffered absolute declines in the number of their daily subscribers, notwithstanding growth in the number of households in most markets and the substantial marketing and other efforts on the part of the newspapers to obtain new subscribers as the old ones were lost. (*See also* Tr. at 202-13, 227-36, and J.A. 138-51). Moreover, the President of the Booth Newspapers, Werner Veit, testified that the subscriber relationships at issue here are not self-regenerating. (*See* Tr. at 492-97.)

In sum, to apply the government's universally discredited mass asset fiction to Ledger's 460,000 specific subscriber relationships flies in the face of the actual wasting characteristics of these assets—proven at trial, found by the district court and not disturbed by the Third Circuit on appeal.[11]

III.

THE DEPRECIATION OF LEDGER'S ACQUIRED SUBSCRIBER RELATIONSHIPS DOES NOT RESULT IN A DOUBLE DEDUCTION

The government argues that disallowing depreciation deductions for Ledger's wasting assets should be tolerated because taxpayers, like Ledger, are permitted to take annual deductions for current expenses incurred "maintaining and promoting" these same assets. (Gov't Br. at 29-30.) The government's "double deduction" argument is without merit.

Most significantly, the "double deduction" argument rests upon the government's mischaracterization of the assets at issue in this case. Ledger did not depreciate a mass "circulation base"; it depreciated 460,000 specific relationships acquired at a specific point in time. (*See supra* at 11-14.) The fact that extensive promotional efforts had to be undertaken, and expenses incurred, to obtain new subscribers to replace those

11 This case is, therefore, distinguishable from any case where an asset was actually found to self-regenerate. For example, in *Ithaca Industries, Inc.* v. *Commissioner*, 97 T.C. 253 (1991) (cited in Gov't Br. at 23, 42), the Tax Court denied a depreciation deduction for a "work force in place" because the taxpayer had failed to establish *as a matter of fact* that the asset had an ascertainable life and value—not because the asset was *per se* self-regenerating or nondepreciable goodwill. 97 T.C. at 269, 271 ("we conclude from the facts here present that petitioner's assembled work force was not a wasting asset"). In this case, however, Ledger established that its subscriber relationships had determinable lives and ascertainable values and were not self-regenerating. Moreover, the Tax Court in *Ithaca* specifically distinguished this case, and other similar cases involving customer-based assets, on the ground that any new subscriber relationship developed by Ledger is an asset distinct from the previously acquired wasting subscriber relationships. *Id.* at 268, 270.

which were lost confirms that the 460,000 purchased subscriber relationships were *not* self-regenerating. *(See supra* at 13-14.) In short, the two deductions to which the government refers apply to completely *different* assets.

The depreciation deduction reflects the annual diminution in the value of the 460,000 *purchased* subscriber relationships. The annual current expense deduction applies to expenses, such as subscription drives, incurred to acquire *new* subscriber relationships. Indeed, the same analysis would apply if the purchased subscriber relationships were embodied in fixed-term contracts. The government concedes that such assets would be depreciable. If Ledger had to expend additional resources to obtain new fixed-term subscribers as the old fixed-term contracts terminated, these costs would be separately accounted for, whether capitalized or expensed, based on the particular facts presented. *See INDOPCO, Inc.* v. *Commissioner*, 112 S. Ct. 1039 (1992). In this case, such costs are indisputably deductible as current expenses pursuant to the express congressional mandate of section 173 of the Internal Revenue Code.[12]

Not even the deduction for costs incurred to maintain the *original* 460,000 subscriber relationships results in a double deduction. Ledger's deductions to maintain its existing subscriber relationships are no different from the deductions taken by taxpayers to maintain indisputably depreciable tangible assets. (*See* Pet. App. at 41a.) For example, a machine that has a useful life of ten years is without question depreciable over a ten-year period pursuant to section 167. However, without proper maintenance, the machine's useful life might be significantly diminished. Accordingly, in *addition* to the depreciation deduction under section 167, Congress has also provided a current deduction for costs incurred to maintain depreciable assets, for only by expending these maintenance costs will the asset achieve its true useful life. *See* Treasury Regulation 1.162-4.[13]

12 In fact, not only is there no double deduction in this case, but the government actually enjoys an advantage in the collection of taxable income. This is because there is a lack of symmetry in the timing of the tax treatment between the seller and the purchaser of a business which favors the government—not the taxpayers. The Booth Newspapers' seller was subject to tax on the full amount of the gain in the year of sale. However, Ledger, the purchaser, is required to deduct the cost of its expenditure over the assets' useful lives—in some cases more than 20 years.

Finally, the government suggests that the administrative difficulty in allocating "ordinary business expenses" to generate new customers (*e.g.*, advertising expenses) between the "current" expense component—which aids the production of income only within the current taxable year—and the "capital" expense component—which aids the production of income for more than one year—somehow justifies denying the depreciation of Ledger's subscriber relationships. (Gov't Br. at 30-31.) Without citing any authority, the government contends that the IRS has "adopted" a solution to this allocation problem pursuant to which taxpayers are allowed a current expense deduction for all expenses to generate new customers (customers the government characterizes as "goodwill") and denied depreciation deductions for "goodwill." (*Id.* at 32.) By making this trade-off, the government asserts, an equitable matching of income and expenses is achieved. (*Id.*)

13 The government posits that, if Ledger's subscriber relationships were deemed depreciable intangible assets under section 167, then they would also be subject to a loss deduction under section 165 of the Code. (Gov't Br. at 29 n.25.) This, the government argues, would be "absurd" because, unlike an irreparable machine which requires the taxpayer to incur costs to acquire a new machine, the loss of one subscriber relationship is automatically accompanied by the gain of another subscriber relationship. (*Id.*) The government's attempt to accord disparate tax treatment to intangible and tangible assets directly conflicts with its own admission that *both* types of assets are subject to depreciation deductions under section 167. (*Id.* at 12.) Ledger's subscriber relationships, like a machine, do *not* self-regenerate. (*See supra* at 12-13.) Accordingly, in order to achieve proper matching, if Ledger's wasting subscriber relationships unexpectably terminate—for example, an explosion kills all of the subscribers to the newspaper—then the loss of those relationships is, in fact, deductible under section 165 because Ledger will have to incur substantial expense to obtain new subscribers. *See* Rev. Rul. 71-418, 1971-2 C.B. 125 (accountant who purchased a single client account and capitalized the cost of the account was also entitled to a loss deduction under section 165 when the client died).

This argument is utterly unfounded and has no relevance to this case. The argument is unfounded because, as the government concedes, depreciation deductions are not permitted for goodwill because it is an asset that has no determinable life. (*Id.* at 13-16.) In any event, Ledger has never argued that it is entitled to depreciate "goodwill" and, at the same time, currently deduct expenses to build "goodwill." At issue *in this case* are the " '*old*' subscriber relationships that [Ledger] purchased from Booth." (Gov't Br. at 30 n.26) (emphasis added). As the government concedes, Ledger was *not* entitled to take a current expense deduction for these assets in the year that they were purchased (*id.*), and Ledger did not do so. Accordingly, to also deny Ledger a depreciation deduction for these wasting assets would clearly distort Ledger's annual matching of earnings and expenses.

The argument is irrelevant because the *new* subscribers Ledger may have obtained subsequent to the acquisition of the Booth Newspapers—and the expenses incurred to obtain them—are *not* at issue here. (*See* Pet. App. at 40a.) Nevertheless, even if some of Ledger's expenses to secure *new* subscriber relationships aid the production of income for more than one year, Congress has expressly allowed taxpayers in the publication industry, like Ledger, to take a current expense deduction for these expenses. 26 U.S.C. § 173. Ledger does *not*, however, receive an additional depreciation deduction for the assets secured by these expenses. Accordingly, unless Congress amends section 173 of the Code, neither the Court nor the IRS may compel Ledger to capitalize any expenses to obtain new subscriber relationships. *See Hanover Bank* v. *Commissioner*, 369 U.S. 672, 688 (1962) ("the Government now urges this Court to do what the legislative branch of the Government failed to do or elected not to do. This, of course, is not within our province"); *International Trading Co.* v. *Commissioner*, 484 F.2d 707, 711 (7th Cir. 1973) ("Our task is to construe and apply, not to write, legislation").

CONCLUSION

The government concedes that, in order to achieve the proper matching of income and expenses in a particular taxable period, all wasting assets *shall* be depreciable and that goodwill is not depreciable only because it is an asset which does not waste. Ledger's assets, unlike goodwill, were proven and found to waste and not to self-regenerate—findings not disturbed by the Third Circuit on appeal. The government's position in this case, therefore, is directly at odds with its own concessions and the plain words of section 167 of the Internal Revenue Code. Accordingly, in order to apply the congressional mandate of section 167, this Court should reverse the judgment below—denying Ledger a depreciation deduction for its wasting assets—and give effect to the fundamental precept of the federal revenue laws that income tax is a tax on net—not gross—income.

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Supreme Court of the United States
OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.
as successor to The Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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for the Third Circuit**

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF AMICUS CURIAE

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of the Petitioner, Newark Morning Ledger Co.[1] Tax Executives Institute (herein-

[1] Tax Executives Institute has received the written consents of the Petitioner and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

after "TEI" or "the Institute") is a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and currently represents more than 4,800 members who are employed by 2,000 of the leading corporations in the United States and Canada. The members of the Institute represent a cross-section of the business community in North America.

TEI is dedicated to promoting the uniform, systematic, and equitable interpretation and enforcement of the tax laws. It is also dedicated to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers. This case implicates fundamental questions concerning the tax treatment of acquired intangible property. TEI is concerned about the potential effect of the Third Circuit's flawed opinion on the ability of taxpayers to depreciate the intangible wasting assets that are used in their businesses. As the individuals who must contend daily with the interpretation and administration of the nation's tax laws, the Institute's members have a vital interest in the proper disposition of this case.

SUMMARY OF ARGUMENT

This case involves whether a newspaper's paid subscribers acquired by purchase and having a limited useful life may be depreciated for federal income tax purposes. The outcome turns on whether an intangible asset has an ascertainable value and a useful life separate and distinct from goodwill.

Section 1.167(a)-3 of the Income Tax Regulations sets forth a fact-based standard for determining whether an asset may be depreciated: (1) does the intangible asset have a limited useful life?, and (2) if so, can that useful life be estimated with reasonable accuracy? The regulations do not, however, permit a deduction for goodwill. Although the regulations do not define that term, the

courts have filled the gap by defining goodwill to be the expectancy that "old customers will resort to the old place," *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963) (citing *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897, 901 (5th Cir. 1962)), and "the expectancy of continued patronage, for whatever reason." *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962). Thus, "goodwill" may be fairly equated with "good name" —that is to say, the ephemeral aura that surrounds a viable business until some event intervenes to reduce or eliminate it.

In the landmark case of *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1249-50 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), the court reasoned that early cases denying a current depreciation deduction had generally turned on the failure of the taxpayer to prove its case. The court held that under the Internal Revenue Code an intangible asset—including a customer-based intangible—may be depreciated if the taxpayer satisfies a two-prong test: (1) the intangible has an ascertainable cost basis separate and distinct from goodwill and going concern value, and (2) the intangible has a limited useful life. *Id.* at 1251. Since that time, the courts have generally agreed that depreciability of a particular intangible asset is a question of fact.

In this case, the taxpayer unquestionably demonstrated that the customer-based intangible here at issue—the newspaper's paid subscribers—had an ascertainable value separate and distinct from goodwill and a limited useful life. The United States Court of Appeals for the Third Circuit conceded as much, but averred that "there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable."

The Third Circuit's opinion is wrong. Under the case law, a depreciation deduction is not denied because an intangible is called "goodwill"; rather, it is denied because the intangible does not have a determinable useful life or value. Obversely, if an intangible asset has an ascertainable value and a limited useful life, it is—by definition—separate and distinct from goodwill and may be depreciated under section 167(a) of the Code. The label is not controlling, the facts are.

The legal standard propounded by the Third Circuit would imprison taxpayers in the straitjacket of nondeductibility. Such a result would not only be at odds with the statute, but would deny taxpayers the benefit of modern valuation methodologies. Hence, although taxpayers in earlier cases may have been unable to sustain their factual burden under the regulations, the refinement of valuation and measurement techniques has undeniably enabled taxpayers in appropriate cases to meet their burden. As the District Court found, the taxpayer both proved the separate and distinct value of the customer-based intangible here in issue and reasonably estimated its useful life. There is no principle of tax law or precept of tax administration that justifies denying a depreciation deduction.

Moreover, the Third Circuit's rejection of the residual method of valuation flouts Congress's express determination that such a method is a legitimate means of valuing tangible and intangible assets. In section 1060 of the Code, Congress mandated the use of the residual method for allocating the consideration paid among the assets—including intangible assets—conveyed in certain acquisitions. Congressional endorsement of the valuation method underscores the flawed nature of the Third Circuit's logic.

As the Court recognized earlier this term in *Indopco, Inc. v. Commissioner*, 60 U.S.L.W. 4173 (U.S. Feb. 26, 1992) (No. 90-1278), "the Code endeavors to match expenses with the revenues of the taxable period to which

they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." *Id.* at 4174 (citing *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974), and *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983). The Third Circuit facilely rejects this fundamental matching principle by effectively precluding the taxpayer from recovering its costs over the useful life of the affected assets. The court's opinion is therefore wrong as a matter of sound tax policy.

Finally, the Third Circuit's decision marks a radical departure in the legal principles employed in determining the depreciability of customer-based intangibles. *Amicus* TEI respectfully suggests that if the tax treatment of customer-based intangibles is to be so fundamentally changed, it is for Congress to decide. Contrary to the Third Circuit's decision, Congress has not stood mute on this issue. Rather, it has specifically chosen not to act. That the Third Circuit would judicially legislate a new rule is wholly improper. "If the [taxpayer] has found a hole in the tax dike, the problem must be corrected by applying the thumb of Congress, not the Court's." *Apple Computer, Inc. v. Commissioner*, 98 T.C. No. 18 (Dkt. No. 34127-87), at n.4 (1992), *reprinted in* [1992] Tax Ct. Rep. (CCH) 4759, 4762 n.4 (citing *Fabreeka Products Co. v. Commissioner*, 294 F.2d 876, 879 (1st Cir. 1961)).

The decision of the U.S. Court of Appeals for the Third Circuit should be reversed.

ARGUMENT

I. CUSTOMER-BASED INTANGIBLES MAY BE DEPRECIATED

This case involves whether intangible property acquired by purchase and having a limited useful life may be depreciated under the Internal Revenue Code. The resolution of this issue turns on whether an intangible asset (such as the paid subscribers at issue here) has an ascertainable value and a useful life separate and distinct from goodwill. Applying the statutory and regulatory provisions, the District Court found that the taxpayer had sustained its burden of proof. (App. 32a.)[2] The United States Court of Appeals for the Third Circuit, however, denied the dispositive nature of the taxpayer's uncontroverted factual showing and reversed the District Court on the ground that, as a matter of law, the intangible property was an integral part of goodwill and therefore non-depreciable. (App. 28a-29a.) *Amicus* TEI submits that the Third Circuit's opinion is fundamentally wrong.

Consistent with the basic principles of a net income tax, the Internal Revenue Code affords taxpayers a deduction for ordinary and necessary expenses incurred in carrying on any trade or business. Taxpayers are not, however, customarily permitted to deduct currently the costs associated with acquiring capital assets whose useful lives extend beyond the end of the taxable year. These expenditures must be capitalized and depreciated or amortized over the life of the asset or, if no specific useful life can be ascertained, upon the disposition of the asset (through sale or abandonment) or the dissolution of the enterprise. 26 U.S.C. §§ 167(a), 336(a) [hereinafter cited as "I.R.C." or "the Code"]; *Indopco, Inc. v. Commissioner*, 60 U.S.L.W. 4173, 4174 (U.S. Feb. 26, 1992) (No. 90-1278).[3]

[2] References to "App." are to the appendix filed with Newark Morning Ledger Co.'s Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

The current rule for depreciating intangible assets is set forth in section 1.167(a)-3 of the Treasury Department's Income Tax Regulations:[4]

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

Thus, the regulations set forth a fact-based standard: (1) does the intangible asset have a limited useful life?, and (2) if so, can that useful life be estimated with reasonable accuracy?[5] If the taxpayer can answer the two

[3] The deduction for depreciation was first enacted by the Revenue Act of 1913 which provided a reasonable allowance for "wear and tear of property arising out of its use or employment in the business." Revenue Act of 1913, 38 Stat. 114, 167. The term "depreciation" is generally used with respect to tangible property; the term "amortization" is generally used in reference to intangible assets. Stanley S. Surrey, Paul R. McDaniel, Hugh J. Ault & Stanley A. Koppelman, *Federal Income Taxation* 464 n.13 (Successor ed. 1986). To avoid confusion, the term "depreciation" is used hereinafter to refer to both depreciation and amortization.

[4] Provisions of the Income Tax Regulations (26 C.F.R.) are hereinafter cited as "Treas. Reg. §." Provisions of temporary income tax regulations are cited as "Temp. Regs. §."

[5] The courts have accorded taxpayers substantial flexibility in estimating the useful lives of both tangible and intangible assets. *See, e.g., Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1253-54 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129

questions affirmatively, a depreciation deduction will be allowed; if the facts cannot be marshalled to so answer the questions, a current deduction is not permitted.

The regulatory disallowance of a depreciation deduction for "goodwill"—set forth in the last sentence of the quoted language—has been virtually unchanged since its promulgation in 1927.[6] This is not to say, however, that no question exists about the relationship between the disallowance and the core rule that intangibles may be depreciated. The issue turns on the scope of the term "goodwill," which the regulations themselves do not define. Courts, however, have defined the term for tax purposes to be the expectancy that "old customers will resort to the old place," *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963) (citing *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897, 901 (5th Cir. 1962)), and "the expectancy of continued patronage, for whatever reason." *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962). Thus, "goodwill" may be fairly equated with "good name"—that is to say, the ephemeral aura that surrounds a viable business until some event intervenes to reduce or eliminate it.

Several early cases denied taxpayers a deduction for customer-based intangibles, essentially on the grounds that the taxpayers had failed to sustain their factual burden under the regulations of distinguishing the intangible

(1974) ("Extreme exactitude in ascertaining the duration of an asset is a paradigm that the law does not demand. All that the law and regulations require is reasonable accuracy in forecasting the asset's useful life."); *Liquid Paper Corp. v. United States*, 2 Cl. Ct. 284, 298 (1983) (requiring only "reasonable predictions of probable future developments").

[6] Article 163 of Treasury Regulations 69 generally provided that intangible assets were depreciable if they had a limited useful life. The regulation stated that "[n]o deduction for depreciation, including obsolescence, is allowable in respect of good will." T.D. 4055, VI-2 C.B. 63 (Aug. 4, 1927).

from goodwill. *See, e.g., Golden State Towel & Linen Serv. v. United States*, 373 F.2d 938, 941 (Ct. Cl. 1967) (terminable-at-will customer list is indivisible from goodwill and therefore non-depreciable); *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 681 (5th Cir. 1971) (leaseholds possess same qualities as goodwill, have no ascertainable useful lives, and are self-regenerating). These cases applied a "mass asset" rule pursuant to which arguably distinct assets were deemed to be "inextricably" linked to goodwill. In 1973, however, this juridic shorthand was rejected by the Fifth Circuit, which held in *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1249-50 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), that the mass asset rule did not "establish a *per se* rule of non-amortizability in every case involving both goodwill and other intangible assets." Reasoning that these early cases turned on the failure of the taxpayer to prove its case, the court concluded that under the regulations an intangible asset—including a customer-based intangible—may be depreciated if the taxpayer satisfies a two-prong test: (1) the intangible has an ascertainable value separate and distinct from goodwill and going concern value;[7] and (2) the intangible has a limited useful life. *Id.* at 1251.

Since the *Houston Chronicle* case, the courts have generally agreed that whether an intangible asset is depreciable is a question of fact. *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463, 479 (1988), *aff'd per*

[7] "Going concern value" has been defined as "the additional element of value which attaches to property by reason of its existence as an integral part of a going concern." *UFE, Inc. v. Commissioner*, 92 T.C. 1314, 1323 (1989) (quoting *VGS Corp. v. Commissioner*, 68 T.C. 563, 591 (1977), *acq.*, 1979-1 C.B. 1). Although the distinction between goodwill and going concern value is often blurred by the courts, the tax law treats both intangibles as nondepreciable assets. *VGS Corp.*, 68 T.C. at 592; *Illinois Cereal Mills v. Commissioner*, 46 T.C.M. (CCH) 1001, 1023 (1983), *aff'd on other grounds*, 789 F.2d 1234 (7th Cir.), *cert. denied*, 479 U.S. 995 (1986).

curiam, 919 F.2d 1492 (11th Cir. 1990); *Decker v. Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988); *Donrey, Inc. v. United States*, 809 F.2d 534, 536 (8th Cir. 1987); *Banc One Corp. v. Commissioner*, 84 T.C. 476, 492 (1985), *aff'd*, 815 F.2d 75 (6th Cir. 1987); *Liquid Paper Corp. v. United States*, 2 Cl. Ct. 284, 297 (1983); *Los Angeles Central Animal Hosp. v. Commissioner*, 68 T.C. 269, 273 (1977), *acq.*, 1978-1 C.B. 1; and *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223, 232 (1975), *acq.*, 1976-1 C.B. 1. *See also* Stanley S. Surrey, Paul R. McDaniel, Hugh J. Ault & Stanley A. Koppelman, *Federal Income Taxation* 480 (Successor ed. 1986) ("This [mass asset] approach was rejected by the courts, which held that the issue in such cases was one of fact.").[8]

That an intangible asset—including a customer-based intangible—may be subject to depreciation was conceded by the Internal Revenue Service (IRS) itself in the year following the *Houston Chronicle* decision. Rev. Rul. 74-456, 1974-2 C.B. 65. Clearly, the taxpayer has the burden of showing the fact and rate of depreciation with "reasonable certainty" or a "reasonable approximation," *Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648, 654-55 (1931), but one thing should be immutable: customer-based intangibles have a limited useful life and are therefore depreciable. *See Citizens & Southern Corp., supra*, & cases cited therein. As recently as three weeks ago, the new Chief Judge of the U.S. Tax Court confirmed the depreciability of such assets explicitly on the grounds that they are separate and distinct from goodwill. *See Peoples Bancorporation v. Commissioner*, T.C. Memo. 1992-285 (Dkt. No. 29058-89) (May 18, 1992) (Hamblen, J.) (core deposits of a bank are depreciable). Notwithstanding the clear consensus, the IRS has persisted in strictly applying Rev. Rul. 74-456 and challenging the depreciability of particular intangible assets on both legal and factual grounds.

[8] Only one court in the last 20 years has embraced the "mass asset" rule, and even there the court held that the issue involved a question of fact with respect to which the taxpayer had failed to meet its burden of proof. *AmSouth Bancorporation v. United States*, 681 F. Supp. 698, 712-13 (N.D. Ala. 1988).

In this case, the taxpayer unquestionably demonstrated that the customer-based intangible here at issue—the newspaper's paid subscribers—had an ascertainable value separate and distinct from goodwill and a limited useful life. Indeed, these facts were conceded by the government. (App. 9a, 32a.) Nevertheless, the Third Circuit—casting aside the language of the regulations and the teaching of established law—averred that "there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." (App. 29a.) The Third Circuit thus invoked the term "goodwill" as a shibboleth to deny the core rule in the regulations and to deprive taxpayers an opportunity to establish their entitlement to a deduction for wasting assets.

The Third Circuit's opinion is wrong as a matter of law. Under the case law, goodwill is not depreciable because it "has no determinable economic life apart from the business as a going concern. It ordinarily is *not* assignable apart from the business to which it applies. It continues in varying value as long as the business." *Dodge Bros v. United States*, 33 F. Supp. 312, 317 (D. Md. 1940), *aff'd*, 118 F.2d 95 (4th Cir. 1941) (emphasis in original). In contrast, an asset having a "determinable economic life apart from the business as a going concern" is *not* goodwill and, hence, not subject to the regulatory disallowance. As the Court of Claims succinctly held in 1976, "[t]he most significant indication that an intangible asset is separate and distinct from good will is whether its useful life can be shown with reasonable accuracy to be of limited duration." *Richard S. Miller & Sons v. United States*, 537 F.2d 446, 452

(Ct. Cl. 1976). *Cf. Illinois Cereal Mills v. Commissioner*, 46 T.C.M. (CCH) 1001, 1024 (1983), *aff'd on other grounds*, 789 F.2d 1234 (7th Cir. 1986), *cert. denied*, 479 U.S. 995 (1986) (goodwill is not subject to depreciation because its useful life is not suspectible of reasonable estimation); *Colorado Nat'l Bankshares v. Commissioner*, 60 T.C.M. (CCH) 771, 789 (1990) ("It is these characteristics [separate values and lives] which separate [the deposit accounts] from general goodwill and permit separate valuation."). Again, the issue is a factual question, not a legal one.

A recent report by the U.S. General Accounting Office summarized the evolution of the intangible asset depreciation rule, as follows:

> In 1927, the Department of the Treasury published regulations containing the first statement that goodwill is not amortizable. Goodwill was generally viewed as having an indeterminable useful life. Without a determinable useful life, there was no period over which to recover the asset's cost, and therefore, no deduction could be calculated or allowed under the statutory provision.

U.S. General Accounting Office, *Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets* (GAO/GGD-91-88) 18 (August 1991). Congress has likewise recognized that "because goodwill does not have a determinable useful life, no depreciation deduction is allowed with respect to that intangible asset." H.R. Rep. No. 495, 100th Cong., 1st Sess. 936 (1987) (Conference Report on the Omnibus Budget Reconciliation Act of 1987).

The Third Circuit's tautology notwithstanding, a depreciation deduction is not denied because an intangible is labelled "goodwill"; rather, it is denied because the intangible, whatever its label, has an indeterminate useful life. Obversely, if an intangible asset has an ascertainable value and a limited useful life, it is—by definition—separate and distinct from goodwill and may be depreciated under section 167(a) of the Code. The label is not controlling, the facts are.

The Third Circuit argued that because the intangible in this case contributed to continued patronage, it is, *ipse dixit*, indistinguishable from goodwill. (App. 10a-12a, 28a.) Such a standard, however, has been expressly rejected by other courts. *E.g., Citizens & Southern Corp.*, 91 T.C. at 481. Moreover, the court's reasoning is flawed because many expenses that are currently deductible undeniably contribute to continued patronage. For example, advertising is intended to build and sustain patronage, yet the expenses of advertising are deductible for tax purposes. Treas. Reg. § 1.162-1(a) (advertising and other selling expenses are generally deductible); Treas. Reg. § 1.162-20(a) (deduction allowed for institutional or goodwill advertising). If the Third Circuit's logic were carried to the extreme, as a matter of law *nothing* would be depreciable because virtually *all* business expenditures contribute in some way to continued patronage and goodwill. Such a result, of course, would eviscerate the core rule in the regulations and, indeed, section 167 itself.[9]

The legal standard propounded by the Third Circuit would imprison taxpayers in the straitjacket of nondeductibility. Such a result would not only be at odds with the statute, but would also deny taxpayers—and, indeed, the tax system—the benefit of modern valuation methodologies. Hence, although taxpayers in earlier cases may have been unable to sustain their factual burden under the regulations, the refinement of valuation and measurement techniques has enabled taxpayers to over-

[9] The Third Circuit's reasoning could easily be extended to the absurd. If "contribution to continuing patronage" is the standard, it should then apply with equal vigor to both tangible and intangible property. Thus, an efficient machine producing superior products or a structure attractive to customers would fail the depreciability test simply because it enhances customer patronage.

come their burden. As the District Court found—and neither the government nor the Third Circuit disputed—the taxpayer in this case both proved the separate and distinct value of the customer-based intangible here in issue and reasonably estimated its useful life. There is no principle of tax law or precept of tax administration that justifies denying a depreciation deduction because, in the past, the factual burden of proof could not have been sustained.

Consider an analogy from astronomy. In the 1600s, Galileo used a primitive telescope and observed what he believed to be satellites surrounding the planet Saturn. More sophisticated equipment, however, led over time to a series of other discoveries, each of which supplanted its precursor—first, that there was a single ring of a solid sheet of material, then a multitude of rings, and finally that there are actually seven rings, consisting of thousands of narrow ringlets, which themselves are made up of billions of pieces of ice. By utilizing increasingly powerful scientific instruments, astronomers have been able to discern that what was once thought to be a single, undifferentiated ring around Saturn in reality consists of billions of separate and distinct components.

Measurement and valuation techniques in respect of intangible assets have assuredly not been as long lived or dramatic as the scientific scrutiny of Saturn's rings, but there should be no mistake: the Third Circuit's analysis represents the legal equivalent of using Galileo's primitive telescope and insisting that customer-based intangibles are indistinguishable from goodwill notwithstanding the information available from Voyager space probes and the Hubble telescope.

Having chosen to ignore clear evidence of the depreciability of customer-based intangibles, the Third Circuit sought to rationalize its holding by differentiating between intangibles purchased in an acquisition and those purchased separately. (App. 17a.) The distinction, however, is without significance, for even though customer-based intangibles may be purchased as part of an acquisition of a business, they may also be purchased separately. Equally important, there is no legal or economic reason to condition depreciability on the terms of sale. As the Fifth Circuit observed in *Laird v. United States*, 556 F.2d 1224, 1234 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978), "[i]t does not matter for purposes of amortization if individual assets only have economic significance in the context of an integrated transaction involving the sale of a number of assets." *Accord Citizens & Southern Corp.*, 91 T.C. at 492-93 ("[I]t is irrelevant for purposes of depreciation that deposit base cannot be separately transferred and only has economic significance in the context of a bank."). Stated differently, the view that depreciability must turn on factual bases "is more in accord with the realities of modern business technology in a day when lists are bartered and sold as discrete vendible assets." *Houston Chronicle*, 481 F.2d at 1253.[10]

To convert an inherently factual issue into a court-made legal decree always favoring the government is to nullify the longstanding and fundamental tax principle that

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[10] Nor is it dispositive that the subscriber relationship here at issue was terminable at will. Such a finding may affect the value of the intangible or its useful life, but it "does not as a matter of law prevent petitioner from factually showing that [the intangible] has an ascertainable cost basis separate and distinct from goodwill and that it has a reasonable ascertainable useful life." *Citizens & Southern Corp.*, 91 T.C. at 486 (discussing core deposit accounts). *See Super Food Servs. v. United States*, 416 F.2d 1236, 1240 (7th Cir. 1969) (it is immaterial that the contractual relationship may have no fixed termination date). As the Fifth Circuit rightly observed in *Houston Chronicle*, "[a]ll that the law and regulations require is reasonable accuracy in forecasting the asset's useful life." 481 F.2d at 1254. *See Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128, 139-41 (8th Cir. 1960) (Blackmun, J., concurring) (if the asset is shown to be a wasting one used in taxpayer's trade or business, a reasonable deduction must be allowed).

wasting assets are depreciable. The taxpayer here demonstrated that its paid subscribers were a wasting asset with a limited useful life and an ascertainable value separate and distinct from goodwill. That is all the Code and regulations require to entitle the taxpayer to a depreciation deduction.

II. THE RESIDUAL METHOD IS A VALID MEANS OF VALUING INTANGIBLES

The Third Circuit intimated that its holding may have been different if the taxpayer had used a different method for valuing the paid subscribers. (App. 30a.) In a somewhat murky fashion, the court seemed to reject the residual method of valuation used by the taxpayer here and to hold that in all events the taxpayer's deduction would be limited to the amount derived from using the cost method of valuation. (App. 28a-30a.) Such an analysis is seriously flawed and flouts Congress's express determination that the residual method is a legitimate means of valuing tangible and intangible assets.

Under the residual method, goodwill is essentially that which remains after all the other property—tangible and intangible—has been valued. Congress affirmed the validity of this method as recently as six years ago. In section 1060 of the Code, Congress mandated the use of the residual method of allocating the consideration paid among the assets—including intangible assets—conveyed in certain acquisitions.[11] The prescribed allocation method divides the purchase price into four components, with the last group being the repository for intangible assets in the nature of goodwill or going concern value. Thus, under the residual method, goodwill is what is left after all other allocations have been made. Temp. Reg. § 1.1060-

[11] Under section 1060 of the Code, the allocation must be made for purposes of determining both the seller's gain or loss with respect to the transaction and the buyer's basis in the assets received.

1T(d)(1) and (2). *Accord* I.R.C. § 338(a)(5); Temp. Reg. § 1.338(b)-2T(b) (requiring an identical method of allocating purchase price to assets following a stock purchase).

In adopting section 1060, Congress evinced the view that the residual method is a proper means of allocating the purchase price among the assets in an acquisition. *See* Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d Sess. 358-59 (1987). Congressional endorsement of the residual method of valuation underscores the flawed nature of the Third Circuit's logic.[12]

III. THE THIRD CIRCUIT'S DECISION VIOLATES THE TAX LAW'S FUNDAMENTAL MATCHING PRINCIPLE

Ominously, the Third Circuit's opinion gives short shrift to a fundamental principle of the income tax system: the matching of income with associated expenses on an annual basis. The Internal Revenue Code imposes a tax based on *net* taxable income, *i.e.*, the amount remaining when a taxpayer's expenses are subtracted from its gross receipts. As this Court recognized earlier this term in *Indopco, Inc. v. Commissioner*, "the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." 60 U.S.L.W. at 4174 (citing *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974), and *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983)). The annual accounting system is a "practical necessity if the federal income tax is to produce revenue ascertainable and payable at regular intervals." *Hillsboro Nat'l Bank*

[12] The residual method is also embraced for purposes of computing the value of goodwill for financial reporting purposes. Accounting Principles Board Opinion No. 16, *Business Combinations*, and No. 17, *Intangible Assets* (August 1970).

v. Commissioner, 460 U.S. 370, 377 (1983) (citing *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931)). *See* I.R.C. § 446(b); Treas. Reg. § 1.446-1(a)(2) (requiring a taxpayer to adopt a method of accounting that clearly reflects income).

From the inception of the income tax, a taxpayer has been permitted to recover its capital costs through a deduction for depreciation. Surrey, *et al.*, *supra*, at 464. This Court has explained the depreciation deduction, as follows:

> [Depreciable] assets, employed from day to day in business, generally decrease in utility and value as they are used. It was the design of the Congress to permit the taxpayer to recover, tax free, the total cost to him of such capital assets; hence it recognized that this decrease in value—depreciation—was a legitimate tax deduction as a business expense. It was the purpose of [the depreciation provisions] to make a meaningful allocation of this cost to the tax periods benefited by the use of the asset.

Massey Motors, Inc. v. United States, 364 U.S. 92, 96 (1960). In other words, it is through the depreciation deduction that a taxpayer is able to recoup the true cost of an asset. *Cf. Idaho Power Co.*, 418 U.S. at 10. *See also* H.R. Rep. No. 1337, 83d Cong., 2d Sess. 22 (1954) (Conference Report on Internal Revenue Code of 1954) ("Depreciation allowances are the method by which the capital invested in an asset is recovered tax-free over the years it is used in a business.").

The result mandated by the Third Circuit distorts the matching principle by effectively precluding taxpayers from recovering their costs. "Denying amortization deductions [for goodwill and similar intangibles] does not result in an accurate determination of taxable income since expenses are not properly matched to income generated." U.S. General Accounting Office, *Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets* (GAO/GGD-91-88) 5 (August 1991). To the extent a

depreciation deduction is denied, a taxpayer is taxed on other than its net income. The decision below would vitiate the statutory requirement to clearly reflect income.[13]

The Third Circuit's opinion is therefore wrong as a matter of sound tax policy.

IV. IT IS FOR CONGRESS TO DECIDE WHETHER THE TAX TREATMENT OF CUSTOMER-BASED INTANGIBLES SHOULD BE CHANGED

The Third Circuit's decision marks a radical departure in the legal principles to be employed in determining the depreciability of customer-based intangibles. *Amicus* TEI respectfully suggests that if the tax treatment of customer-based intangibles is to be so fundamentally changed, it is for Congress to decide. Contrary to the Third Circuit's assertion (App. 28a), Congress has not stood mute on this issue. Rather, it has specifically chosen not to act.

In 1987, the House of Representatives passed H.R. 3545 which included a provision that any amount paid or incurred to acquire customer base, market share, or any renewing or similar intangible item was to be treated as paid or incurred for intangible property with an indeterminate useful life, thereby rendering the customer-based intangible nondepreciable. *See* H.R. 3545, 100th Cong., 1st Sess. § 10120 (1987). The provision was not, however, included in the Senate version of the bill and was dropped during negotiations between the House and

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[13] The Third Circuit's decision is similarly contrary to the matching principle prescribed in governing financial reporting standards. For financial accounting purposes, taxpayers must record as assets the costs of acquired intangible assets and amortize the cost of each intangible over the period estimated to be benefited (not to exceed 40 years). Accounting Principles Board Opinion No. 17, *Intangible Assets* (August 1970); Financial Accounting Standards Board, Statement of Financial Standards No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions* (February 1983).

Senate conferees. H.R. Rep. No. 495, *supra*, at 937-38. In the Conference Report on the 1987 legislation, Congress acknowledged that "[a] substantial portion of the purchase price of a business is frequently allocated to certain intangible assets that represent the value of the existing customer base, and amortized over the period it is estimated that those customers may be lost." *Id.* at 937. It chose, however, *not* to alter that treatment. Legislation introduced since that time to limit depreciation deductions for intangible assets has similarly *not* been enacted. *See, e.g.*, H.R. 563, 102d Cong., 1st Sess. (1991). Indeed, earlier this year, the IRS supported and Congress enacted legislation to require the depreciation of intangibles—including goodwill—over a specific period of time. H.R. 4210, 102d Cong., 2d Sess. § 4501 (1992). The legislation, however, was vetoed by the President.

The depreciation of customer-based intangibles is not an area in which Congress has been passive and detached. Rather, it is an area in which Congress has explicitly demonstrated an awareness of the current law and has deliberately chosen not to amend it. Thus, even if the depreciation of intangibles somehow were found to violate fundamental tax law principles—and, in fact, it clearly does not—it is not for the Third Circuit to legislate a new rule. "If the [taxpayer] has found a hole in the tax dike, the problem must be corrected by applying the thumb of Congress, not the Court's." *Apple Computer, Inc. v. Commissioner*, 98 T.C. No. 18 (Dkt. No. 34127-87), at n.4 (1992), *reprinted in* [1992] Tax Ct. Rep. (CCH) 4759, 4762 n.4 (citing *Fabreeka Products Co. v. Commissioner*, 294 F.2d 876, 879 (1st Cir. 1961)). *See also Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 367 (1931) (relief from allegedly burdensome statute afforded only by legislation, not the courts).

Moreover, Congress *has* focused on amending the tax treatment of other intangibles. Thus, in 1988, Congress enacted section 167(r) of the Code, which provided that no depreciation deduction is allowed with respect to any

trademark or trade name. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1002(i). This provision was repealed the next year. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7622(b)(1) (1989).

In other words, when Congress has deemed it appropriate to act on the tax treatment of intangibles, it has done so. *See Fabreeka Products*, 294 F.2d at 879 n.3 ("It may not be irrelevant to note that when Congress did amend the statute . . . it made a change in no way corresponding to what the government now proposes."). The legislature's specific refusal to disallow a deduction for customer-based intangibles should not now be overturned by judicial fiat.

CONCLUSION

For the foregoing reasons, the decision of the U.S. Court of Appeals for the Third Circuit should be reversed.

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
as successor to the Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF FOR COLORADO NATIONAL BANKSHARES, INC. AND SUBSIDIARIES AS AMICUS CURIAE SUPPORTING PETITIONER

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INTEREST OF THE AMICUS

Colorado National Bankshares, Inc. and Subsidiaries ("CNB") has a vital interest in this case. In a case currently before the United States Court of Appeals for the Tenth Circuit, CNB is urging the Tenth Circuit to affirm a decision of the Tax Court, which holds that CNB is entitled to amortize acquired core deposit intangibles. *Colorado Nat'l Bankshares, Inc. v. Commissioner*, 60 T.C.M. (CCH) 771 (1990), *appeal filed*, No. 91-9019

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[1] Colorado National Bankshares, Inc. and Subsidiaries submits this brief with the consent of both parties. Consent letters from the parties, copies of which previously have been mailed to the Clerk of the Court, are filed with this brief.

(10th Cir. filed Sept. 27, 1991). In the *CNB* case, as here, the government advocates a *per se* rule, denying as a matter of law amortization of customer- or supplier-based intangible assets acquired in the purchase of a going concern. Although the facts in the *CNB* case are distinguishable in a number of significant respects from the present case, this Court's decision as to whether Morning Ledger is entitled to amortize its acquired subscriber base, if written broadly, could influence the final outcome of the *CNB* case.

SUMMARY OF THE ARGUMENT

The Court of Appeals' opinion is inherently contradictory. Although the Third Circuit conceded that the amortization of intangible assets presents a factual question, Pet. App. 16a, the court nevertheless decided the case based on a *per se* rule. The *per se* rule would force all cases involving the amortization of customer- or supplier-based intangibles acquired as part of a going concern into a single mold—regardless of actual facts or economic reality—and deny amortization deductions as a matter of law. Pet. App. 28a-29a. This Court should not adopt such an inflexible approach.

The *per se* rule relied upon by the Third Circuit cannot be reconciled with the language of the controlling statute and regulation, represents an unnecessary departure from the current facts and circumstances test used to distinguish between amortizable intangible assets and non-amortizable goodwill, and—because of its inflexibility—may force courts to stretch the facts of individual cases to fit the rule. This Court, therefore, should reverse the decision below and refuse the government's invitation to adopt a *per se* rule covering all intangible assets based on customers or suppliers, in all industries, acquired under differing facts and circumstances.

ARGUMENT

I. A *PER SE* NON-AMORTIZATION RULE CANNOT BE RECONCILED WITH CURRENT LAW

The Third Circuit began its analysis by acknowledging that the *Houston Chronicle* test "has become the standard for all subsequent related cases." Pet. App. 16a (citing *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974)). The court, furthermore, agreed with the government's statement that "the two-prong test articulated by *Houston Chronicle* was intended to inter the notion that some intangible assets, although not necessarily goodwill, [are] nonetheless so intertwined with goodwill as to be nondepreciable as a matter of law in all cases." *Id.* However, and notwithstanding the foregoing, the circuit court concluded that "the Service is correct in asserting that, for tax purposes, there are some assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." Pet. App. 28a-29a. This, of course, is the precise *per se* rule *Houston Chronicle* purportedly interred.

The *per se* rule should not be resurrected. The controlling statute and regulation are clear, and the previous cases are unanimous: whether a taxpayer is entitled to amortize a specific intangible asset is a question of fact to be determined at the trial court level. Accordingly, the Third Circuit erred in adopting a *per se* non-amortization rule.

A. A *Per Se* Rule Cannot Be Reconciled With the Language of the Controlling Statute and Regulation

To match accurately the expense of acquiring a capital asset with the income generated by that asset, the Internal Revenue Code and its implementing regulations allow for

the depreciation[2] of capital assets. Section 167(a) of the Code provides that "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income." Treasury regulation section 1.167(a)-3 provides an annual deduction for intangible assets if the intangibles are "known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy . . . ." Treas. Reg. § 1.167(a)-3.[3]

Neither section 167 nor the implementing regulation sets forth a *per se* rule that denies, as a matter of law, amortization deductions with respect to customer- or supplier-based intangibles acquired in the purchase of a going concern. Admittedly, Treasury regulation section 1.167(a)-3 flatly prohibits the amortization of goodwill. However, the regulation does not define goodwill. Therefore, in a controversy involving the amortization of an intangible asset, the language of the controlling statute

[2] As a matter of terminology, "depreciation" deductions are allowed for tangible assets and "amortization" deductions are allowed for intangible assets.

[3] Treasury regulation section 1.167(a)-3 provides in full:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to good will. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder. For rules with respect to trademark and trade name expenditures, see section 177 and the regulations thereunder.

and regulation requires a court to distinguish, on a factual, case-by-case basis, the value of the asset to be amortized from the value of goodwill.

B. A *Per Se* Rule Directly Conflicts With the Legal Standard That Has Been in Effect for Nearly Twenty Years

The modern legal standard used to distinguish amortizable intangible assets from non-amortizable goodwill was first articulated by the Fifth Circuit in *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1249-50 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974). Recognizing that the concept of goodwill cannot be defined with any precision, the court set forth the following factual test: a taxpayer is allowed to take amortization deductions with respect to any intangible asset "if the taxpayer properly carries the dual burden of proving that the intangible asset involved (1) has an ascertainable value separate and distinct from goodwill and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy." *Houston Chronicle*, 481 F.2d at 1250. Since 1973, each of the eight circuit courts that have addressed issues involving the amortization of intangible assets, including the Third Circuit, have unanimously adopted the *Houston Chronicle* test and recognized the factual nature of the test.[4]

One year after the *Houston Chronicle* case was decided, the Internal Revenue Service officially adopted the same test:

[4] *See* Pet. App. 16a; *Citizens and Southern Corp. v. Commissioner*, 91 T.C. 463, 479 (1988), *aff'd per curiam without opinion*, 900 F.2d 266 (11th Cir. 1990); *Decker v. Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988); *Southern Bancorporation, Inc. v. Commissioner*, 847 F.2d 131, 136-37 (4th Cir. 1988); *Panichi v. United States*, 834 F.2d 300, 301 (2d Cir. 1987); *Donrey, Inc. v. United States*, 809 F.2d 534, 537 (8th Cir. 1987); *McCarthy v. United States*, 807 F.2d 1306, 1310 (6th Cir. 1986); *Ralph W. Fullerton Co. v. United States*, 550 F.2d 548, 550 (9th Cir. 1977).

> The depreciability of assets of this nature [customer- or supplier-based intangibles acquired in the purchase of a going concern] is a *factual question*, the determination of which rests on whether the taxpayer establishes that the assets (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy.

Rev. Rul. 74-456, 1974-2 C.B. 65, 66 (emphasis added).

The Third Circuit attempted to justify its departure from the fact-based *Houston Chronicle* test by stating that "[i]n the context of the sale of a going concern, it is simply often too difficult for the taxpayer and the court to separate the value of [a customer- or supplier-based intangible] from the goodwill value of the customer relationship/structure." Pet. App. 29a. This statement demonstrates the need for a factual test as opposed to a *per se* rule.

The factual nature of the *Houston Chronicle* test results from the unique characteristics possessed by the myriad different intangible assets that can be acquired in the purchase of a going concern and from the elusiveness of the concept of goodwill. Precisely because it is "often difficult" to distinguish between amortizable intangible assets and non-amortizable goodwill, the trier of fact must be allowed to weigh all of the evidence presented in a case before deciding whether the value of the asset sought to be amortized is separate and distinct from the value of goodwill. The court's perceived difficulty is insufficient justification for a *per se* rule.

The Third Circuit's reliance on a *per se* rule in reaching its decision in this case is in direct conflict with section 167(a), Treasury regulation section 1.167(a)-3, and the fact-based legal standard that has been consistently applied by eight circuit courts for a total of nearly twenty years. Therefore, the Third Circuit's decision must be reversed by this Court.

II. THE THIRD CIRCUIT HAS NOT ARTICULATED A PERSUASIVE JUSTIFICATION FOR DEPARTING FROM THE *HOUSTON CHRONICLE* TEST

Based on the specific facts and circumstances of the case before it, the Third Circuit determined that, in valuing the acquired subscriber base using the stream-of-income method of valuation, Morning Ledger included "much or all of the value of the expectancy that those customers [would] continue their patronage—i.e., the goodwill of the acquired concern." Pet. App. 30a. In addition, the court ignored the clear difference between customer-based intangibles and supplier-based intangibles. In an apparent attempt to bolster the resulting conclusion that Morning Ledger was not entitled to amortize the subscriber base, the Third Circuit transformed its case-specific, factual premises into a *per se* rule applicable to all cases and all circumstances. The court's erection of a *per se* rule on these premises, however, evidences faulty inductive reasoning and represents an unnecessary departure from the *Houston Chronicle* test.

A. A Conclusion That the Stream-Of-Income Method Does Not Result in a Value That Is Separate and Distinct From Goodwill Does Not Mean Other Methods of Valuation Cannot Produce a Value That Is Separate and Distinct From Goodwill

From its premise that the stream-of-income method includes goodwill in valuing the subscriber base acquired by Morning Ledger, and therefore does not satisfy the *Houston Chronicle* test, the Third Circuit jumped to a *per se* rule, denying as a matter of law amortization deductions with respect to all customer- or supplier-based intangibles acquired in the purchase of a going concern. The court's premise, however, even if valid, does not mean that methods of valuation other than the stream-of-income method cannot produce a value for customer- or supplier-based intangibles that is separate and distinct from the value of acquired goodwill. For example, taxpayers have success-

fully shown that the cost-savings method of valuation produces a value for acquired core deposit intangibles that is separate and distinct from goodwill. *See, e.g., Citizens and Southern Corp. v. Commissioner*, 91 T.C. 463, 480 (1988), *aff'd per curiam without opinion*, 900 F.2d 266 (11th Cir. 1990).

A bank's right to use the core deposits [5] existing on the date of an acquisition is an intangible asset known as a "core deposit intangible." To the extent that a bank is able to use acquired core deposits to meet its existing loan demand, instead of being forced to turn to more expensive market alternatives for funds, the bank realizes a determinable cost savings.[6] The present value of the total cost savings is the value of the acquired core deposit intangible. In the *CNB* case, the Tax Court found that "[i]t is this benefit which [CNB] set up as an asset and depreciated." *Colorado Nat'l Bankshares*, 60 T.C.M. (CCH) at 789.

In valuing core deposit intangibles acquired in the purchase of an existing bank, the cost-savings method produces a value that is separate and distinct from the value of the goodwill acquired in the transaction. *See, e.g., Citizens and Southern Corp. v. Commissioner*, 91 T.C. 463, 510 (1988), *aff'd per curiam without opinion*, 900 F.2d 266 (11th Cir. 1990); *Colorado Nat'l Bankshares*, 60 T.C.M. (CCH) at 793. Thus, in the *CNB* case, the

[5] "Core deposits" are funds deposited in interest-free checking accounts, interest-bearing checking accounts ("NOW" accounts), and savings accounts. Core deposits are a bank's cheapest source of funds, are relatively insensitive to interest rate changes, and, when acquired, decline over a predictable period of time.

[6] In *Dickman v. Commissioner*, 465 U.S. 330, 336 (1984), *reh'g denied*, 466 U.S. 945 (1984), this Court recognized that "the use of valuable property—in this case, money—is itself a legally protectible property interest" and held that an interest-free loan results in a taxable gift from the lender to the borrower. The value of the gift is measured by the interest costs saved by the borrower. *See also* I.R.C. § 7872.

Tax Court allowed CNB to amortize only the value for its acquired core deposit intangible that could be demonstrated using the cost-savings method. *Colorado Nat'l Bankshares*, 60 T.C.M. (CCH) at 793.

The Third Circuit itself noted that the "preference for the cost[-savings] approach is not premised merely on some obscure aspect of financial theory. . . . [T]he difference in the two valuation approaches implicates the central legal dilemma at issue." Pet. App. 29a-30a. Although the court indicated that the stream-of-income method (when used to value a customer-based intangible) inherently includes much or all of the value of the goodwill of the acquired business, the court strongly suggested that, if Morning Ledger had valued the subscriber base using the cost-savings method, amortization of the subscriber base would have been allowed. Pet. App. 30a. The Third Circuit's own admission that valuation methods other than the stream-of-income method presented in the *Morning Ledger* case can be used to satisfy the *Houston Chronicle* test invalidates its *per se* rule, and demonstrates that the *per se* rule is an unnecessary departure from established law.

B. A Conclusion That a Customer-Based Intangible Is Not Separate and Distinct From Goodwill Does Not Mean That Supplier-Based Intangibles Cannot Be Shown To Be Separate and Distinct From Goodwill

From its premise that a particular customer-based intangible was not shown to be separate and distinct from goodwill under one set of facts, the Third Circuit constructed a *per se* rule, denying as a matter of law amortization deductions with respect to all customer- or supplier-based intangibles acquired in the purchase of a going concern. As with the court's reasoning regarding the stream-of-income method, this premise does not compel the adoption of a *per se* rule. In the core deposit cases, taxpayers have successfully demonstrated that core deposit

intangibles, which are supplier-based intangible assets, are separate and distinct from goodwill.

A bank does not generate profits from its core deposits;[7] it generates profits by lending money to its borrowers. When a bank acquires the core deposits of another bank, the purchaser gains the right to use the money deposited in the acquired core deposit accounts for an ascertainable period of time. Throughout that period, the core deposits are a readily available, low-cost source of funds.

In terms of generating profits, a bank's customers are its borrowers.[8] A bank's depositors, on the other hand, are its suppliers, supplying the bank with its raw material (lendable funds) at a below-market rate. In this respect, the acquisition of a core deposit intangible is much the same as a manufacturer's acquisition of the right to receive raw materials at a below-market price—*i.e.*, a favorable supply contract.

A favorable supply contract is valuable to a manufacturer because it lowers the manufacturer's cost of producing its product, and thereby increases its profit margin. Similarly, a supply of low-cost funds allows a bank to produce its product (loans) at a cost below that achievable using alternative sources of funds. In both instances the value of the asset is measured by the costs saved, rather than by the income attributable to the asset.[9]

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[7] Typically, a bank does not charge a service fee on savings accounts, and the fees charged on checking accounts do not fully cover the costs of maintaining the accounts.

[8] Banks and finance companies both generate profits by lending money at interest rates higher than the rates they must pay for the right to use the money. However, finance companies cannot accept deposits as a source of lendable funds; they issue commercial paper on the open market in much the same way that banks without sufficient core deposits are forced to issue certificates of deposit. Even though a finance company does not have depositors, it is not a business without customers; like a bank, its customers are its borrowers.

[9] *See, e.g., Ithaca Indus., Inc. v. Commissioner*, 97 T.C. 253, 97 Tax Ct. Rep. (CCH) No. 16 (1991), *appeal filed*, No. 92-1045 (4th Cir. filed Jan. 15, 1992) (taxpayer permitted to amortize favorable supply contracts valued using the same method employed by the Tax Court in valuing CNB's acquired core deposit intangibles—the cost-savings method).

The Third Circuit founded its *per se* rule on two determinations derived from the particular facts and circumstances of the *Morning Ledger* case. Regardless of the validity of these determinations, it does not follow that all customer- or supplier-based intangibles, in all industries, are non-amortizable under all facts and circumstances. Even if the Third Circuit's factual premises accurately represent the record of the *Morning Ledger* case, they have absolutely no validity in the context of other cases, particularly those involving the amortization of supplier-based intangibles valued using the cost-savings method. They do not, in short, support the creation of a *per se* rule applicable to *all* cases involving amortization of customer- or supplier-based intangibles. This Court, therefore, should not accept the government's invitation to adopt the *per se* rule advanced by the Third Circuit.

III. THE *PER SE* RULE IS UNWISE BECAUSE IT CREATES A PROCRUSTEAN BED INTO WHICH COURTS MUST FORCE THE FACTS OF DIFFERING CASES

The Third Circuit's opinion demonstrates the procrustean nature of a *per se* rule and the reason why such a rule should not be adopted by this Court. In an attempt to justify its departure from *Houston Chronicle*, the Third Circuit was forced to mischaracterize the factual findings made by various trial courts. Based on these mischaracterizations, the Third Circuit then claimed that the *Houston Chronicle* test was unworkable because trial courts were incapable of properly applying the two-prong test.

Based on its reading of the facts and circumstances surrounding Morning Ledger's purchase of the Booth Newspapers, the Third Circuit suggested that the district court collapsed the two-prong *Houston Chronicle* test into

a one-prong determination: whether the asset sought to be amortized, the subscriber base, had a determinable life that was capable of being ascertained with reasonable accuracy. Pet. App. 9a. In effect, the Third Circuit claimed that the district court confused an administrative task, *i.e.*, ascertaining a value for an asset, with one of the fundamental requirements for amortization, *i.e.*, that the taxpayer must factually demonstrate that the asset sought to be amortized has a value separate and distinct from the value of the acquired goodwill. Pet. App. 13a.[10]

To support its theory that trial courts are incapable of properly applying the *Houston Chronicle* test, and thus to justify its resort to a *per se* rule, the Third Circuit cited the Tax Court's opinion in *Colorado Nat'l Bankshares* and claimed that the Tax Court, too, had reduced the *Houston Chronicle* test to a one-prong determination. Without the benefit of viewing the evidence presented in the *CNB* case, the Third Circuit stated that "[t]he Tax Court rejected the Service's position, clearly adopting the view that any intangible asset possessing a determinable life and an ascertainable value is, by definition, not goodwill." Pet. App. 22a. To the contrary, however, the Tax Court actually required (1) proof that the core deposit intangibles CNB sought to amortize had values that were separate and distinct from the value of the goodwill of the acquired banks, *Colorado Nat'l Bankshares*, 60 T.C.M. (CCH) at 787-90, and (2) proof of a limited useful life, the duration of which was ascertainable with reasonable accuracy. *Id.* at 790-92.

The Tax Court recognized that it must "first decide whether [CNB] established that its core deposit intangibles have an ascertainable value separate and distinct

[10] If the Third Circuit did, in fact, base its decision on the district court's misapplication of the *Houston Chronicle* test, it was required to set forth the proper legal standard and remand the case to the district court for additional factual findings consistent with, and a proper application of, the *Houston Chronicle* test.

from goodwill." *Id.* at 787. After reviewing all of the evidence presented in the case, the Tax Court concluded: CNB "has proven that the core deposits intangible at issue here has an ascertainable cost basis separate and distinct from the goodwill and going concern value of the acquired banks." Id. at 789-90.[11]

The Third Circuit's tendency to view all customer- or supplier-based intangible assets acquired in the purchase of a going concern as being identical facilitated the court's mischaracterization of the *CNB* case. If the Third Circuit had not ignored the facts, *i.e.*, that the *CNB* case involved a supplier-based intangible valued using the cost-savings method, the court would have been forced to recognize that its decision in the *Morning Ledger* case was completely inapplicable to the *CNB* case.

[11] Contrary to the Third Circuit's assertion that the Tax Court reduced the *Houston Chronicle* test to a one-prong determination, the Tax Court has consistently required taxpayers to prove that, in addition to having a limited useful life, the asset sought to be amortized has a value separate and distinct from goodwill. *See, e.g., Citizens and Southern Corp. v. Commissioner*, 91 T.C. 463, 480 (1988), *aff'd per curiam without opinion*, 900 F.2d 266 (11th Cir. 1990) ("[a]s a threshold matter, petitioner must establish that deposit base is an asset separate and distinct from goodwill").

Judge Goffe's 1988 opinion in *Citizens and Southern* was reviewed by the entire Tax Court and affirmed *per curiam* by the Eleventh Circuit. It is significant to note that the *CNB* case, decided by the Tax Court only two years after *Citizens and Southern* and involving very similar facts, was issued as a memorandum decision. Tax Court decisions are released in memorandum form only when the Chief Judge of the Tax Court determines that the decision concerns the interpretation of a factual question and the application of those facts to established law. Paul H. Frankel, *Tax Court-Trial of Cases*, 153-4th Tax Mgmt Income (BNA) at A-23 (Apr. 8, 1991); *see also* William A. Raabe, Gerald E. Whittenburg, and John C. Bost, *West's Federal Tax Research* 113 (West 1987). Therefore, the Chief Judge, when he issued the decision below as a memorandum decision, signaled his belief that the court in *Colorado Nat'l Bankshares* applied the same legal standard set forth in *Citizens and Southern*.

In the *CNB* case, the taxpayer was able to demonstrate that the asset it sought to amortize (1) had a value that was separate and distinct from the value of goodwill and (2) had a limited useful life, the duration of which could be ascertained with reasonable accuracy. If the Third Circuit found that Morning Ledger did not satisfy the two-prong *Houston Chronicle* test with respect to the acquired subscriber base, the court should have disallowed the taxpayer's amortization deductions. It should not have adopted a *per se* rule. A finding that the facts of one case do not meet the *Houston Chronicle* test does not mean that the test cannot properly be met under any circumstances. The Third Circuit itself has demonstrated that, if a *per se* rule is to govern the amortization of intangible assets, the facts of amortization cases will have to be stretched to meet the rule.

CONCLUSION

Controversies involving the amortization of customer- or supplier-based intangible assets acquired as part of a going concern present questions of fact that must be answered by the trier of fact in each individual case. Thus, the *per se* rule adopted by the Third Circuit should be rejected.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1992

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY,
Petitioner,

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF AMICUS CURIAE MAGAZINE PUBLISHERS OF AMERICA, INC. IN SUPPORT OF PETITIONER

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BRIEF OF AMICUS CURIAE MAGAZINE PUBLISHERS OF AMERICA, INC. IN SUPPORT OF PETITIONER

INTEREST OF AMICUS CURIAE

Amicus Magazine Publishers of America, Inc. (MPA) is a national trade association incorporated under the laws of the State of New York. It submits this brief in support of the petitioner.[1] MPA's membership includes 235 publishing firms that publish 1,193 consumer interest magazines. MPA

[1] Written consent of the parties has been filed with the Clerk of the Supreme Court pursuant to Rule 37.

members' publications include mass-circulation weeklies, monthly home and fashion magazines, journals of opinion, non-profit publications, and a wide variety of special interest publications. These publications are the leading magazines in an industry which delivers approximately 9,000,000,000 subscription copies per year and sells approximately 2,400,000,000 single issues per year through retail outlets.

MPA members regularly acquire, collect and maintain extensive subscription and other demographic information regarding the subscribers to their publications.

In the 1980s a number of MPA members purchased magazines in asset or asset-equivalent acquisitions involving billions of dollars. In these acquisitions, it was the usual circumstance that only a small portion of the purchase price represented the value of the tangible assets acquired. Among the intangible assets acquired in almost every transaction were paid subscribers, finite groups with statistically predictable, limited useful lives and values determined using appraisal methods commonly chosen in everyday business circumstances. These acquired subscribers were not only customers, they also served as assets used in the business to attract advertising revenues. This factor is significant because in a majority of MPA member circumstances, advertising revenue is equal to or a greater portion of a magazine's revenues than is circulation revenue.

The MPA member acquisition transactions were planned and executed with the expectation, based upon decided cases and respondent's own rulings and acquiescences, that the amounts expended for the acquired subscribers would be amortizable over the limited useful life which that asset was predicted to have in the acquirer's publishing business. Contrary to its earlier pronouncements, respondent now challenges not only the applicable Code and regulatory provisions, but also the fundamental economic and tax

assumptions upon which both buyers and sellers conceived and executed their transactions.

SUMMARY OF ARGUMENT

The Third Circuit misperceived the applicable precedent and created a conflict among the circuits. It substituted a restricted definition of goodwill found in the case law for the tax law description of depreciable intangible assets and nondepreciable (residual) goodwill found in the Treasury regulations. It also completely ignored the time-honored principle that the essence of goodwill, as a tax concept, is its indeterminate life. While it relied upon *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974), it ignored the Fifth Circuit's rejection of "the establishment of a *per se* rule and a monolithic 'mass asset' theory that would amalgamate all subscriptions lists with goodwill." *Id.* at 1253.

In its March 16, 1992 brief in this case on the petition for writ of certiorari, respondent compounded the Third Circuit's misperception by arguing erroneously that a talismanic change occurred in the Treasury regulations in 1927. The precedent upon which respondent relied in making this argument demonstrates that the new, 1927 version of the pertinent Treasury regulation included no change in the principle that has always existed in the Treasury regulations: where it can be shown that an intangible asset has a limited life and an ascertainable value depreciation is allowable.

Though the Third Circuit relied upon numerous cases for a definition of goodwill (Pet. App. at 23a-25a), it ignored the fact that in practically all these cases the court also held as a matter of law that where a taxpayer could show that it had acquired an intangible asset having a limited life and an ascertainable value, depreciation was allowable. Addition-

ally, the Third Circuit also failed to cite or rely upon the latest cases from the circuits which have considered the same issue.

Finally, the District Court provided in its "galaxy of customers" description an appropriate "bright-line" test to distinguish between a customer-based intangible asset which has a limited useful life and nondepreciable goodwill.

For these reasons, the Court should reverse the decision of the Third Circuit.

ARGUMENT

I

THE THIRD CIRCUIT HAS MISPERCEIVED THE APPLICABLE LAW AND TREASURY REGULATIONS AND HAS CREATED A CONFLICT AMONG THE CIRCUITS

A. The Essence of Goodwill as a Tax Concept is its Indeterminate Useful Life

The decision of the Third Circuit is in direct conflict with decisions in a number of the Circuits.[2] It is the result of a

[2] The relevant Circuit Court opinions are: *Houston Chronicle Publishing Co. v. United States, supra; Laird v. United States,* 556 F.2d 1224 (5th Cir. 1977), cert. denied, 434 U.S. 1014 (1978); *Super Food Services, Inc. v. United States,* 416 F.2d 1236 (7th Cir. 1969) (separate intangible assets found to exist in purchase of grocery store business; this taxpayer victory was not mentioned in *Decker v. Commissioner,* 864 F.2d 51 (7th Cir. 1988)); *Donrey, Inc. v. United States,* 809 F.2d 534 (8th Cir. 1987) (acquisition of a business, including customer based intangible assets; holding that in *General Television, Inc. v. United States,* 598 F.2d 1148 (8th Cir. 1979), it held "[e]ntitlement to a

fundamentally flawed analysis of the applicable statutory and regulatory provisions and case law.

Goodwill has been an elusive tax concept. While a number of judicial definitions of this term have been attempted, including those referring to continued patronage,[3] these definitions fall short of a proper tax analysis. Such an analysis makes clear that the essence of goodwill as a tax concept is its indeterminate useful life. Where a limited useful life can be shown for a specific intangible asset, such asset is not, for tax purposes, included in goodwill. This is evident from the plain language of the Code and respon-

depreciation allowance for an intangible asset is a question of fact." 809 F.2d at 536); *Commissioner v. Seaboard Finance Co.,* 367 F.2d 646 (9th Cir. 1966); *Citizens & Southern Corp. v. Commissioner,* 919 F.2d 1492 (11th Cir. 1990) (core deposit accounts acquired in the acquisition of a bank are depreciable); *Richard S. Miller & Sons, Inc. v. United States,* 537 F.2d 446 (Ct.Cl. 1976); see also *Panichi v. United States,* 834 F.2d 300, 302 (2d Cir. 1987) (purchase of a customer list only, and not an entire business; the Second Circuit did not hold that had the customer list been purchased with an ongoing business a different tax result—nondepreciability—would have followed).

[3] See *Boe v. Commissioner,* 307 F.2d 339, 343 (9th Cir. 1962); but see *Commissioner v. Seaboard Finance Co., supra,* holding that the result in *Boe* would have been different if the taxpayer there had carried his factual burden of valuing the individual contracts that he acquired. 377 F.2d at 652-53. See also *Los Angeles Central Animal Hospital, Inc. v. Commissioner,* 68 T.C. 269, 273-74 (1977), acq., 1978-2 C.B. 2 (holding that medical files acquired in the acquisition of an ongoing business were an intangible asset separate and distinct from goodwill and, consequently, could be depreciated). The significance of the Commissioner's acquiescence in this decision is discussed, *infra,* at Pp. 19-20.

dent's own regulations, as well as the leading precedent in the various Circuits.

In the first place, a deduction for depreciation has always been available for "property used in a trade or business."[4] Second, Congress has never made a distinction between tangible and intangible property in segregating depreciable assets from nondepreciable assets. In the case of all forms of property, the matching principle of associating income and expenses relating to the same tax period has permitted a deduction for depreciation where it has been shown that an asset has a limited and ascertainable life. *Indopco, Inc. v. United States,* 112 S. Ct. 1039, 1043 (1992); see also *Massey Motors, Inc. v. United States,* 364 U.S. 92, 104 (1960):

> . . . the primary purpose of depreciation accounting [is] to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use . . . of the asset to the periods to which it contributes.

In *Northern Natural Gas Co. v. O'Malley,* 277 F.2d 128, 140 (8th Cir. 1960), Justice Blackmun, then a member of

[4] Section 234(a)(7) of the Revenue Act of 1918 provided a deduction for depreciation as follows:

> A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

Section 167 of the Code currently provides—

> a depreciation deduction . . . for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) (1) of *property* used in a trade or business. . . . (Emphasis added.)

Similar provisions have been included in all intervening versions of the Internal Revenue Code.

the Eighth Circuit, commented that tax depreciation should "coincide with good business practice and good accounting."

In the *Newark Morning Ledger* circumstance, and other circumstances with which this amicus is familiar, the acquired paid subscribers are assets used in the trade or business not only as customers, but also as a circulation base necessary to attract revenue from advertising customers. See *Donrey, Inc.,* 809 F.2d at 536; see also Pet. App. at 6a-7a, n.2.

Just as the Congress has not made a distinction between tangible and intangible property in the Internal Revenue Code, no distinction has ever existed between tangible and intangible property in respondent's regulations. For intangible assets, Article 163 of Treasury Regulation 45, promulgated by the Treasury Department with respect to the Revenue Act of 1918 provided:

> *Depreciation of Intangible Property.* Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. *If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance,* provided the facts are fully shown in the return or prior thereto to the satisfaction of the commissioner. There can be no such allowance in respect of good will, trade-names, trade-marks, trade brands, secret formulae, or processes. (Emphasis added.)

Similarly, Treasury Regulation §1.167(a)-3, applicable in the tax period in suit, and currently, provides as follows:

> *If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance.* Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to good will. (Emphasis added.)

In each circumstance, encompassing over 70 years of the tax law, the existence, *vel non*, of a "limited" useful life for an intangible asset has served as the fulcrum between depreciability and nondepreciability.

This focus upon whether an intangible asset has a limited useful life finds parallel support in respondent's Treasury Regulation § 1.167(a)-1(a) and (b). Tangible property used in a trade or business is also depreciable over its "estimated useful life." Just as the notion of continued patronage has never mistakenly been an element in determining the depreciability of a tangible asset, its intrusion into the process of determining the depreciability of an intangible asset is also inappropriate.

B. Respondent Misperceives Treasury Decision 4055 and *Red Wing Malting Co. v. Willcuts*

Respondent erroneously contends that the Commissioner barred a deduction for depreciation of "goodwill" in its 1927 version of its Treasury regulations. *Brief for United States on Petition for a Writ of Certiorari,* at 9. In its March, 1992 Brief to this Court in this case, respondent argued that the prohibition against depreciation of goodwill was first incorporated in the Treasury regulations in 1927.[5] See T.D. 4055, VI-2 C.B. 63. Respondent misperceives Treasury Decision 4055. There, the Commissioner relied upon the decision in *Red Wing Malting Co. v. Willcuts,* 15 F.2d 626 (8th Cir. 1926), cert. denied, 273 U.S. 763 (1927), to add the following sentence to the regulations pertaining to the depreciability of intangible assets (Article 163 of Regulation 45, *supra,* at p.7):

> No deduction for depreciation, including obsolescence, is allowable in respect of good will.

This sentence replaced the last sentence of the same regulation *(Id.)*:

> There can be no such allowance in respect of good will, trade-names, trade-marks, trade brands, secret formulae or processes.

A review of these two sentences raises serious doubt about the accuracy of respondent's contention that the prohibition against depreciation of goodwill was a distinct 1927 regulatory act. In the first place, it is hard to find any difference between the two regulatory sentences quoted above.[6] Conse-

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[5] Respondent provided no limitation of its use of the term "goodwill" in its March 16, 1992 brief. In that the argument was made in the instant case, it is obvious that respondent would include petitioner's paid subscribers intangible asset within its concept of goodwill. Where respondent would draw the line on the outer limits of its position is unclear, but clearly it intends its position to be far-reaching.

[6] If anything, the list of depreciable intangible assets was enlarged by the new regulatory language. No longer was there a

quently, respondent's suggestion that there occurred a talismanic regulatory event in 1927 is more illusory than real.

Second, a close reading of *Red Wing Malting, supra,* reveals respondent's misperception. Red Wing Malting claimed a deduction for the "obsolescence or loss" of its goodwill because its liquor business had become obsolete as a result of the 18th Amendment. *Id.*, 15 F.2d at 627. Red Wing Malting argued that the phrase "including a reasonable allowance for obsolescence," included for the first time in the Revenue Act of 1918, introduced a tax deduction in addition to the allowance for "exhaustion, wear and tear" language of the depreciation statute then in effect. See § 234(a)(7) of the Revenue Act of 1918, *supra*, p. 6, n.4. The Eighth Circuit disagreed, stating (*Id.*, 15 F.2d at 630, 631):

> If it had been intended by the Congress to create a new and additional deduction not connected with property used in the business subject to 'exhaustion, wear and tear,' it would have been very easy for Congress, instead of using the word 'including,' to have said, 'a reasonable allowance for exhaustion, wear and tear and obsolescence of property used in the business.' That would have made the matter clear.
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> * * *
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> . . . the language 'including a reasonable allowance for obsolescence' is but a part of and an enlargement of the previous phrase of the said subsection (7) relating to exhaustion, wear, and tear, and . . . does not add a new kind of deduction, but merely permits the inclusion of an additional element, namely obsolescence of such property. . .

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per se regulatory bar as regards the depreciability of "trade-names, trade-marks, trade brands, secret formulae or processes."

In its 1927 Treasury Decision 4055, respondent plainly stated that this statutory construction by the Eighth Circuit served as the backdrop for its change in the last sentence of the pertinent regulatory language. Upon review of the new and old sentences, *supra*, however, it is evident that all the Commissioner was trying to accomplish was to make clear in the regulation that the introduction of the phrase "including a reasonable allowance for obsolescence" did not add a new kind of deduction (e.g., for "loss" of an intangible asset on account of some act external to the business of the taxpayer) to the then existing statutory and regulatory language.

Viewed in this light, it is evident that respondent's contention that the rule regarding depreciation of goodwill changed in 1927 is simply wishful thinking. The necessary "limited" useful life characteristic of a depreciable intangible asset was unaffected by *Red Wing Malting* and no substantive change occurred in 1927 in the regulatory language.[7] As a matter of law, where a taxpayer is able to satisfy the limited useful life standard, depreciation has always been allowed.

Recently, Congress and respondent have acknowledged the severability of individual intangible assets from the general concept of "goodwill" and the nondepreciable nature (because it has no limited life) of residual goodwill. In enacting Internal Revenue Code §§ 338(b)(5) and 1060,

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[7] This Court reached the same result as in *Red Wing Malting* in another Prohibition-caused obsolescence, or loss, of goodwill case, *Clarke v. Haberle Crystal Springs Brewing Company*, 280 U.S. 384 (1930). The Court stated (*Id.*, at 386-87):

> . . . Congress cannot be taken to have intended such a partial compensation to be provided for by the words 'exhaustion' or 'obsolescence.' Neither word is apt to describe termination by law as an evil of a business otherwise flourishing. . . .

Congress recognized the distinction between nondepreciable goodwill which is a Class IV residual asset and other, severable depreciable Class III intangible assets. Importantly, no reference was made in these statutory enactments to the impact of continued patronage upon the "separate" nature of any distinct Class III intangible asset. Respondent itself has followed this "Class III-Class IV" thematic distinction in its regulations.[8]

In sum, the statutory and regulatory approach to the depreciability of intangible assets has been simple and straightforward. As a matter of law, if a taxpayer can establish that a particular intangible asset has a limited useful life, depreciation has always been allowed.[9] Thus, properly defined and considered in the context of respondent's long-standing regulatory and Congress' historical and newly enacted statutory approach to this issue, a depreciable intangible asset is easily distinguished from residual goodwill by the existence, *vel non*, of a limited useful life.

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[8] See Treas. Reg. § 1.338(b)-2T(b)(2) and § 1.1060-1T(d)(2) where intangible assets are designated as "Class III" assets and goodwill is designated as a residual "Class IV" asset. That Congress and the Treasury would make this distinction seriously undermines respondent's and the Third Circuit's positions.

[9] In *Northern Natural Gas Co. v. O'Malley, supra*, 277 F.2d at 139, then Judge Blackmun wrote in his concurring opinion that if a taxpayer can show that an asset is a wasting one, an allowance for depreciation must be allowed. This language was cited favorably in *Houston Chronicle, supra*, 481 F.2d at 1251.

C. A Number of Circuits Have Recognized the Indeterminate Useful Life Distinction

The Fifth, Seventh, Eighth, Ninth, Eleventh and Federal Circuits and the Tax Court have recognized the importance of the limited useful life distinction and have determined, as a matter of law, that depreciable intangible assets can be segregated from nondepreciable goodwill in the purchase of an ongoing business.[10] To resolve the conflict between these circuits and the Third Circuit it is essential to focus upon the application of the limited useful life requirement by the various courts rather than upon their definitional attempts. The limited useful life requirement has existed in the relevant regulation since before *Red Wing Malting, supra,* and Treasury Decision 4055. No overlay, relating to continued patronage, has ever served, as a matter of law, as a separate distinguishing characteristic between depreciable and nondepreciable intangible assets.

The confusion about what the term "goodwill" has meant in a similar tax circumstance was discussed in *Richard S. Miller & Sons, Inc. v. United States, supra*, 537 F.2d at 450-452. *Miller* was a "limited useful life" case involving insurance contract expirations. The Court of Claims held in *Miller* that if the useful life of an intangible asset could be shown to be of limited duration, and hence a "wasting asset," it would be considered to be an asset separate and

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[10] *Houston Chronicle*, (5th Cir.); *Laird v. United States*, (5th Cir.); *Super Food Services, Inc. v. United States*, (7th Cir.); *Donrey, Inc. v. United States*, (8th Cir.); *Commissioner v. Seaboard Finance Co.*, (9th Cir.); *Citizens & Southern Corp. v. Commissioner*, (11th Cir.); *Richard S. Miller & Sons, Inc. v. United States*, (Ct. Cl.); *IT&S of Iowa, Inc. v. Commissioner*, 97 T.C. 496 (1991); and *Peoples Bancorporation v. Commissioner*, T.C. Memo. 1992-285.

distinct from "goodwill" and, therefore, depreciable.[11] The Court held (537 F.2d at 454, 455):

> An intangible asset is separate and distinct from goodwill when its useful life can be shown with reasonable accuracy to be of *limited* duration. (Emphasis added.)
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> * * *
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> *The Treasury regulations permit depreciation of an intangible asset when the knowledge of its limited useful life can be shown 'from experience or other factors'.* 'Useful life' for depreciation purposes is an estimate, and the length of the useful period must be shown by evidence that allows it to 'be estimated with reasonable accuracy.' *The law does not demand '[e]xtreme exactitude in ascertaining the duration of an asset.'* The appropriate test is whether the particular taxpayer adequately has demonstrated that, in his business, the useful life of the challenged intangible reasonably may be approximated. (Emphasis added; footnotes omitted.)

In its opinion in this matter, the Third Circuit quoted from *Miller* regarding various meanings of the term "goodwill" (Pet. App. at 20a), but ignored the Court of Claims' holding, which relied on the language of Treas. Reg. §1.167(a)-3, *supra*, in distinguishing between depreciable

[11] In *Miller*, the Court held (537 F.2d at 452):

> At the threshold, plaintiffs must show that the 1,383 Arch insurance expirations are separate and distinct from the goodwill that was transferred in the sale. The most significant indication that an intangible asset is separate and distinct from goodwill is whether its useful life can be shown with reasonable accuracy to be of *limited* duration. The most important criterion is whether in fact it is a *wasting asset*. (Emphasis added.)

intangible assets having a limited useful life and nondepreciable goodwill. The Third Circuit held that petitioner had not satisfied its burden of demonstrating that its paid subscribers were *"separate and distinct from goodwill,"* even though petitioner's paid subscribers were found to be a separately identifiable asset with a limited useful life and an ascertainable value. Indeed, the Third Circuit's conclusion flies in the face of the applicable regulatory language. The court stated (Pet. App. at 28a-29a):

> . . . there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable.

Since, as indicated in Part I of this brief, no distinction has been made throughout the history of the Code and the regulations between the depreciability of tangible and intangible assets—each must have a limited useful life and an ascertainable value—the Third Circuit's reasoning crashes to the ground when applied, as it also logically must be, to tangible assets.

The choice which the Third Circuit apparently made to rely on the earlier, non-specific judicial definitions of goodwill, instead of the Code and regulations was improper. Its reliance upon the "separate and distinct" language to reach its conclusion was equally misplaced. This language is not found in the applicable statute[12] or Treasury Regulation.[13] While the "separate and distinct" language apparently had its origin in early case law,[14] its application there suggests that even in 1926, the Eighth Circuit correctly distinguished

[12] See footnote 4, *supra*.

[13] Treas. Reg. §1.167(a)-3, at p. 8, *supra*.

[14] *Red Wing Malting Co. v. Willcuts, supra*, 15 F.2d at 633.

nondepreciable goodwill from depreciable intangible assets having a limited life which may be sold "separate and apart" from an established, ongoing business. Such a depreciable intangible asset as an acquired subscribers group is also an asset which can be used in a business to attract other sales (*i.e.*, advertising).

At this juncture in its opinion, the Third Circuit discussed a series of cases most of which were decided before the Fifth Circuit's landmark decision in *Houston Chronicle Publishing Co. v. United States, supra*, and the Commissioner's confirmation of the correctness of this holding in its own *Rev. Rul.* 74-456, 1974-2 C.B. 65 (where the Commissioner modified its previous rulings "to remove any implication that customer and subscription lists . . . are, as a matter of law, indistinguishable from goodwill possessing no determinable useful life.") The Court focused on language from these cases which described goodwill as the expectancy that old customers will return to the old place without contractual compulsion. (See Pet. App. at 23a-25a.) In so doing, it ignored the rule of law, confirmed in the applicable Code and regulatory provisions noted above, that if a taxpayer can establish that an intangible asset has a limited useful life and an ascertainable value,[15] a depreciation deduction is allowa-

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. . . good will has no existence *separate and apart* from an established business. With the termination of that business it is ended. While a capital asset, it is not the subject of purchase, sale, or assignment separate from the business itself. It is not an assignable asset distinct from the business. It is different in this respect from such intangibles as patents, contracts or franchises which may be sold. (Emphasis added.)

[15] The ascertainable value standard is the second relevant criteria for the depreciation of an intangible asset. Such a standard, however, is easier to satisfy than the limited useful life standard. The bias in the tax law is that practically all assets are susceptible to valuation. *United States v. Davis*, 370 U.S. 65, 72-73 (1962).

ble. Nowhere in the current precedent is there any support for the Third Circuit's conclusion that an intangible asset, having an ascertainable value and a limited life, cannot be depreciated because it is inextricably interwoven with the general goodwill of the business. The Circuits have almost universally held that the intangible value of a business is severable for tax purposes into its identifiable constituent parts.[16]

When the Third Circuit relied upon *Houston Chronicle, supra*, to support its unseverable goodwill conclusion (Pet. App. at 16a), it erroneously overexaggerated the importance of the "separate and distinct" language. Viewed in the context of the holdings in *Red Wing Malting, Miller*, and the decisions of the other Circuits, *supra*, all that the "separate and distinct" language recognizes is that an asset having no ascertainable useful life is nondepreciable goodwill, but that an intangible asset, for which a taxpayer can demonstrate a limited useful life, is depreciable.

This is exactly what the Fifth Circuit held in *Houston Chronicle*. When that court referred to the acquired Houston Press subscription lists as having "an ascertainable value separate and distinct from goodwill" it was referring to "goodwill" in the way that term is used in Treasury Regulation § 1.167(a)-3 (depreciable intangible assets with limited useful lives are separate and distinct from nondepreciable residual *goodwill*). This conclusion is compelled by the Fifth Circuit's additional holding in *Houston Chronicle* (481 F.2d at 1253):

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[16] See footnote 1, *supra*.

> We reject, however, the establishment of a *per se* rule and a monolithic 'mass asset' theory that would amalgamate all subscriptions lists with goodwill.

The Fifth Circuit's holding is further support for taxpayer here since that Court determined that, as a matter of law, if a taxpayer can show that an intangible asset has a limited useful life, such asset is depreciable.

The Third Circuit's reliance upon *Houston Chronicle* for its "separate and distinct" test was misplaced. Houston Chronicle was able to carry its burden of proof that it had acquired an amortizable intangible asset with a limited useful life and an ascertainable value by introducing the following proof (*Houston Chronicle, supra,* 481 F.2d at 1253):

— testimony from taxpayer's officers and employees, based upon their experience as publishers of an afternoon newspaper in the Houston area, regarding the cost of obtaining new subscriptions;

— corroborative testimony from the valuation engineers, based upon their study, discussed supra;

— testimony from taxpayer's officers and employees, again based on their experience, regarding the anticipated useful life of a subscription list used in connection with the publication of an afternoon newspaper in the Houston area;

— corroborative testimony from the valuation engineers, again based upon their study; and

— the results of a survey of *The Houston Chronicle's* current subscribers regarding the useful life of an average subscription, and testimony connecting the survey with *The Houston Press* subscription lists, i.e., testimony that conditions in the afternoon newspaper market in the Houston area had not been materially altered during the years in question.

Similar proof was introduced by petitioner and found by the District Court in this case. (Pet. App. at 33a, *et seq.*)

Respondent's argument that *Houston Chronicle* should be limited to the circumstance where only an amortizable intangible asset and not an ongoing business and its attendant intangible assets are acquired is incorrect. First, the very fact that such intangible assets as customer lists can be freely traded in the market confirms that these assets have a determinable fair market value.[17] Second, the fact that in *Houston Chronicle,* the District Court jury verdict found that in addition to the list of subscribers worth $71,200, the other intangible assets acquired included nondepreciable goodwill worth $775,400 and a covenant not to compete worth $1,809,400 demonstrates that the valuation there was done in the context of an ongoing business. Third, even in its own practices, respondent has agreed with the holding in *Houston Chronicle*[18] and acquiesced in another single asset transfer case, *Manhattan Company of Virginia, Inc. v. Commissioner,* 50 T.C. 78 (1968), government's appeal dismissed (*nolle pros.*), acq., 1974-2 C.B. 3.[19] Fourth, respondent has even acquiesced in cases where the deprecia-

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[17] See *Houston Chronicle, supra,* 481 F.2d at 1253, where the Fifth Circuit recognized that customer lists "are bartered and sold as discrete vendible assets." See also Treas. Reg. §20.2031-1(b) (definition of fair market value); and *United States v. Cartwright,* 411 U.S. 546, 551 (1973).

[18] See *Rev. Rul.* 74-456, *supra.*

[19] 1974-2 C.B. 1: "Acquiescence in a decision means acceptance by the Service of the conclusion reached . . . (but) not necessarily . . . acceptance and approval of any or all of the reasons assigned by the Court for its conclusions."

ble intangible asset was part of an ongoing business and the assets transferred included goodwill.[20] Respondent's acquiescences are inconsistent with the contention that the decisions in *Houston Chronicle* and *Manhattan Company* only permit depreciation of an intangible asset when such an asset is transferred separate from an ongoing business.[21] Respondent's reading of *Houston Chronicle* also ignores the subsequent opinion of the Fifth Circuit in *Laird, supra.* There, the Fifth Circuit extended its *Houston Chronicle* holding to the acquisition of a business having a number of intangible assets. The Court held, "(t)hat the assets contribute value to one another does not prevent their severability for tax purposes." *Laird*, 556 F.2d at 1234.

II
THE THIRD CIRCUIT'S PHALANX OF CASES ARE MERELY YESTERDAY'S WARRIORS

In its opinion, the Third Circuit refers to a " 'phalanx of cases' that have considered the definition and application of the term goodwill in the context of Treas. Reg. § 1.167(a)-3. . . ." (Pet. App. at 23a-25a.) Though these cases are noteworthy for their attempts to define "goodwill," the

[20] *Los Angeles Central Animal Hospital v. Commissioner, supra; Computing & Software, Inc. v. Commissioner,* 64 T.C. 223, 235 (1975), acq., 1976-2 C.B. 1; and *First Pennsylvania Banking & Trust Co. v. Commissioner,* 56 T.C. 677 (1971), acq., 1972-1 C.B. 2.

[21] Respondent's acquiescences are seemingly on a par with its issuance of Private Letter Rulings. While neither is precedential, *per se,* both are examples of respondent's practices in considering such transactions. Numerous taxpayers relied upon respondent's stated practices. *Rowan Cos. v. United States,* 452 U.S. 247, 261, footnote 17 (1981).

Third Circuit erroneously concluded that they also support respondent's position in this case. Merely because a court has defined goodwill in a broad or narrow sense does not mean that the court has also concluded that a separate, depreciable intangible asset cannot be found in the assets of an acquired ongoing business or that respondent has not previously agreed with this legal conclusion.[22] Even more importantly, the cases relied upon by the Third Circuit for a general definition of goodwill are no longer the most recent precedential pronouncements from the various circuits on the issue of whether a depreciation deduction may be allowed with respect to paid subscribers and other similar intangible assets. Though the Court refers to a number of cases from a number of circuits (Pet. App. at 23a-25a), these cases are no longer the law in those circuits.[23]

The Third Circuit cites *Boe v. Commissioner, supra,* but that case has been effectively overruled by *Commissioner v. Seaboard Finance, supra.* The court also cites *Nelson Weaver Realty Co. v. Commissioner,* 307 F.2d 897, 901 (5th Cir. 1962), *Commissioner v. Killian,* 314 F.2d 852, 855 (5th Cir. 1963), *Balthrope v. Commissioner,* 356 F.2d 28 (5th Cir. 1966), and *Winn-Dixie Montgomery, Inc. v. United States,* 444 F.2d 677 (5th Cir. 1971), but these cases were effectively overruled in *Houston Chronicle* and *Laird, supra.*

Though the Fifth Circuit acknowledged in *Houston Chronicle* that its earlier decisions included discussions of "goodwill," it also held that "(n)one of the foregoing cases supports the government's argument that subscription lists

[22] See, *e.g., Commissioner v. Seaboard Finance Co.;* See also *Computing & Software, Inc.;* and *Los Angeles Central Animal Hospital, supra,* where respondent acquiesced in the trial court's holding and did not file an appeal.

[23] See cases cited in footnote 1, *supra.*

are non-amortizable as a matter of law." (*Id.*, 481 F.2d at 1248.) In *Laird, supra,* the Fifth Circuit was even more explicit (quoting from *Griswold v. Commissioner,* 400 F.2d 427, 433 (5th Cir. 1968):

> The property, to be depreciable, must be an inherently wasting asset, but this allowance is not limited to tangible assets.

Clearly, a limited useful life is the key to depreciability whether the asset be tangible or intangible. No additional explicit or implicit statutory or regulatory hurdle exists which prevents a court from applying the correct rule of law: a taxpayer must establish that an intangible asset has a limited useful life and an ascertainable value in order for depreciation to be allowable with respect to that asset.

III

THE DISTRICT COURT'S "GALAXY OF CUSTOMERS" DESCRIPTION PROVIDES A BRIGHT-LINE TEST TO DISTINGUISH BETWEEN A DEPRECIABLE INTANGIBLE ASSET AND NONDEPRECIABLE GOODWILL

The District Court found that taxpayer presented substantial uncontroverted proof about its subscribers and their past subscription practices. The Court held that in identifying a separate, depreciable intangible asset, it was necessary to (Pet. App. at 32a-33a):

> distinguish between a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity and future purchases cannot be predicted, against subscribers who can be predicted to purchase the same item, for the same price on a daily basis.

In so finding, the District Court provided the Court, the respondent and taxpayers with a "bright-line" test to distinguish depreciable customer-based intangible assets from residual nondepreciable goodwill. Ordinarily, newspaper and magazine publishers know their subscribers' history. These subscribers' behavior is statistically predictable and the value of this intangible asset can be determined using appraisal methods commonly chosen in everyday business circumstances. As a result, publishers are capable of satisfying the two-pronged test set forth in Treas. Reg. § 1.167(a)-3. By contrast, those customers who select a newspaper or a magazine from a newsstand and pay cash are properly part of the "galaxy of customers" and a publication's residual goodwill. So too are the cash-only customers of a fast food restaurant or other similar enterprise—they show up at the counter one day, but no one knows whether they will return tomorrow.

In sum, two "bright-line" tests are available to be applied in this circumstance. The first, which the Third Circuit applied ignores the Code, as well as the Commissioner's regulatory and interpretive pronouncements and mandates that a new concept, "continued patronage," must be added—or substituted for—the limited useful life rule included in the regulations.

The second bright-line test, by contrast, is the correct, historical, regulatory rule of law that requires that a taxpayer establish that the intangible asset at issue have a limited useful life. Courts have always been comfortable applying this bright-line test and not all decisions have favored taxpayers.[24] As the Court has recently stated *(Quill Corpo-*

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[24] See, *e.g.*, the cases cited in footnotes 2 and 3. See also the now-overruled cases cited in the opinion of the Third Circuit. Pet. App. at 23a-25a.

ration v. North Dakota, No. 91-194, 1992 U.S. Lexis 3123, 3131, 60 U.S.L.W. 4423, 4427 (May 26, 1992): "Th[e] artificiality [of a bright-line test] is more than offset by the benefits of a clear rule." Unlike the circumstance in *Quill,* there is no artificiality to the Commissioner's interpretative regulations. The "limited useful life" rule of law was established many years ago. The only thing that has changed in the interim is a taxpayer's ability to satisfy the factual test inherent in that rule. The Commissioner's effort to add a new Sisyphean element to its regulatory rule of law—so as to stave off factual proof made possible by the computer age—should be rejected.

CONCLUSION

The decision of the Third Circuit misperceives the applicable statutory and regulatory provisions and disrupts the application of a consistent legal standard in the decisions of the various circuits. The long-standing rule of law regarding the depreciability of intangible assets requires a taxpayer to establish that an intangible asset has a limited useful life and an ascertainable value. These are questions of fact to be determined based upon historical evidence. The Third Circuit's decision is at odds with the precedent in a number of circuits, is wrong as a matter of law and unfairly reallocates the economic bases underlying many recent transactions. The Court should reverse the decision of the Third Circuit.

Respectfully submitted,

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
Petitioner,

v.

UNITED STATES,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF OF DONREY, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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BRIEF OF DONREY, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF THE *AMICUS CURIAE*

Donrey, Inc. ("Donrey"), directly or through subsidiaries, owns and operates newspapers located primarily in the central and western part of the United States. Donrey acquired most of the newspapers it now owns by purchasing them from their prior owners as ongoing businesses. One of the most valuable assets Donrey acquires when it purchases a newspaper is the "subscription list" or "paid subscribers" of the newspaper.[1] An opinion of

[1] The terms "subscription list" and "paid subscribers" have been used to describe the same asset. *Compare* the Third Circuit's opinion below, Pet. App. 1a-30a, *with Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987). Those terms are used interchangeably herein.

this Court determining whether, and under what circumstances, such subscription lists may be amortized could have a significant impact on Donrey's nationwide newspaper enterprises.

Donrey's 1972 acquisition of one newspaper, the Washington (Indiana) Times Herald, was the subject of the Eighth Circuit's opinion in *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987). In the *Donrey* case, the Eighth Circuit addressed the legal question at issue here: *i.e.*, whether a party that acquires a newspaper as a going concern and that values the acquired subscription list based upon the income that the subscription list may be expected to generate may amortize the subscription list over its useful life. The Eighth Circuit held that a taxpayer is entitled to a depreciation allowance for an intangible asset, such as a subscription list, if the taxpayer sustains its burden of proof under the two-pronged test enunciated in *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) and endorsed by the Internal Revenue Service ("IRS") in Rev. Rul. 74-456, 1974-2 C.B. 65, and Rev. Rul. 76-520, 1976-2 C.B. 42. Under the *Houston Chronicle* test, the taxpayer must establish that the intangible asset (1) has an ascertainable value separate and distinct from goodwill; and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy. The Eighth Circuit in *Donrey* held that Donrey had met the *Houston Chronicle* test and was therefore entitled to amortize the subscription list. *Donrey*, 809 F.2d at 536-37.

Amicus believes that the Eighth Circuit's *Donrey* opinion—unlike the decision under review—reflects the proper legal approach to the question presented. Moreover, the *Donrey* decision is based upon an accurate understanding of the nature and function of a newspaper subscription list. The Eighth Circuit, unlike the Third Circuit, has acknowledged the critical fact that a newspaper subscription list is not simply, or even primarily, a list of customers who are expected to generate future subscription revenues. Rather, "the subscription list is an indispensable tool in selling advertising and is not simply a list but instead is used much as a machine to generate advertising revenue." *Id.* at 536.

Although the opinion below is ambiguous in a number of respects, it clearly goes beyond a decision that, in this particular case, the taxpayer failed to carry its burden of proof under the two-pronged *Houston Chronicle* test. Pet. App. 29a-30a. Instead, the Third Circuit apparently has held that subscription lists acquired in connection with the acquisition of ongoing newspaper businesses are not depreciable as a matter of law, at least if they are valued by reference to the income they are expected to generate. *Id.* (customer lists cannot be "valued as the stream of *income* to be generated by the listed customers over their remaining years of patronage" because such value "*inherently includes* much or all of the value of the expectancy that those customers will continue their patronage —*i.e.*, the goodwill of the acquired concern") (first emphasis in original).

In *amicus*' judgment, the Third Circuit's opinion adopts an erroneous rule of law, which rests, at least in part, upon the mistaken belief that newspaper subscription lists are simply customer lists that derive their value solely from the future subscription revenues which the listed customers are expected to provide. In view of the importance of this issue to Donrey and to the newspaper industry generally, Donrey is filing this brief as *amicus curiae* in support of petitioner in this case.[2]

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[2] Pursuant to Rule 37 of the Rules of this Court, the parties have consented to the filing of this brief. Letters of consent from the parties have been filed with the Clerk of this Court.

INTRODUCTION AND SUMMARY OF ARGUMENT

The court of appeals held that petitioner is not entitled to amortize the "paid subscribers" or "subscription lists" of the acquired newspapers despite the fact that petitioner "has demonstrated that the paid subscribers have an ascertainable value and limited useful lives, and that it has presented a reasonably accurate estimate of these useful lives." Pet. App. 9a.[3] The court of appeals thereby articulated a new rule of law: that an "income approach"[4] to valuing a subscription list acquired in connection with the purchase of an ongoing business produces a value for the list that, as a matter of law, is inherently inseparable from goodwill and may not be amortized. *Id.* at 30a.

The Third Circuit's decision below is based upon two fundamental errors. First, the decision cannot be reconciled with the plain meaning of Section 167(a) of the Internal Revenue Code (the "Code"). Second, the new legal rule adopted by the court rests upon a profound misunderstanding of the nature, function and value of a newspaper subscription list.

I.

Section 167(a) of the Internal Revenue Code, 26 U.S.C. § 167(a), provides in clear terms that a depreciation deduction "shall" be allowed for tangible and intangible wasting assets used in a trade or business.[5] Both the

[3] *See* Pet. App. at 28a-29a ("for tax purposes, there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable").

[4] In the opinion below, the Third Circuit refers to a method of valuing an asset that is based upon the income the asset is expected to generate as an "income approach", while it describes a valuation based upon the cost of reproducing the asset as a "cost approach." Pet. App. 29a.

[5] A "wasting" asset is one that, because of exhaustion, wear and tear or obsolescence, is established to be of use in the business or in the production of income for only a limited period, the duration of which may be estimated with reasonable accuracy. *G.W. Van Keppel Co.* v. *Commissioner*, 295 F.2d 767, 770 (8th Cir. 1961).

United States and the court below concede that petitioner has demonstrated that the paid subscribers of the acquired newspapers have an "ascertainable value and limited useful lives," which could be estimated with reasonable accuracy. Pet. App. 9a. The statute mandates a depreciation deduction under such circumstances, and the Third Circuit's decision denying amortization with respect to a concededly wasting asset runs directly counter to the plain meaning of the statute.

The court of appeals based its holding on a vague, general definition of a word, "goodwill," found nowhere in the statute. The term "goodwill" appears solely in one of the interpretive regulations issued by the Department of Treasury under Section 167(a). Treas. Reg. § 1.167(a)-3 (as amended in 1960) (hereinafter the "Treasury Regulation") ("No deduction for depreciation is allowable with respect to good will"). In its opinion, the Third Circuit decided that the label "goodwill" may be affixed to the paid subscribers acquired by petitioner notwithstanding the fact that petitioner is conceded to have established that the paid subscribers are valuable assets with limited useful lives of reasonably ascertainable duration. It thus construed the Treasury Regulation as denying depreciation for business assets which have been shown to meet all the requirements of Section 167(a). So interpreted, the Treasury Regulation is invalid. See *Northern Natural Gas Co.* v. *O'Malley*, 277 F.2d 128, 133-35 (8th Cir. 1960); *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 24-25 (1982).

The court of appeals' interpretation ignores the overriding mandate of Section 167(a) that a depreciation deduction "shall" be allowed with respect to a wasting asset. In contrast, an approach to defining goodwill that

is faithful to the statutory command should ask whether "the reasons for denying amortization deductions for goodwill are fully applicable." See *Houston Chronicle*, 481 F.2d at 1247-48. The regulation's injunction that no depreciation deduction shall be allowed for goodwill simply reflects the fact that—by definition—"goodwill" is not a wasting asset. Indeed, the most salient characteristic of goodwill is that it is self-regenerating and has an *indefinite* useful life; it is an ongoing asset that fluctuates but does not necessarily diminish. See *id.*

Under this analysis, "[t]he most significant indication that an intangible asset is separate and apart from goodwill is whether its useful life can be shown with reasonable accuracy to be of limited duration. The most important criterion is whether in fact it is a wasting asest." *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 452, 454 (Ct. Cl. 1976) (per curiam). See *Colorado Nat'l Bankshares, Inc.* v. *Commissioner*, T.C.M. (P-H) ¶ 90,495, at 2397 (1990). An approach that focuses on the command of the controlling statute—and that interprets the Treasury Regulation in a manner consistent with that command—leads to the inescapable conclusion that a subscription list purchased in the acquisition of a newspaper should, upon the necessary factual showing, be treated as an amortizable asset.

II.

Aside from the error inherent in the Third Circuit's definition of "goodwill," the decision below also rests on a fundamentally flawed assumption regarding the character and value of a subscription list in the newspaper industry. The court of appeals' conclusion that, as a matter of law, a valuation of a subscription list, based on an "income approach," is necessarily inseparable from goodwill rests upon the court's factual assumptions that a subscription list is simply a "customer list" and that

an "income approach" to valuing such a list must solely reflect the expectation of continued patronage by the listed customers. Pet. App. 29a-30a. In this case, it does appear that petitioner's experts derived the value of each subscription list by determining the present value of the subscription revenues that the listed subscribers were expected to produce over the useful life of the list. *Id.* at 6a.

However, this focus on the income stream generated by future subscription revenues is not the only, or even the most appropriate, means of valuing a subscription list. In *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987), for example, the evidence clearly showed that newspapers receive 80 percent of their revenue from advertisers, not subscribers. Advertisers are, however, willing to pay a premium to advertise in a newspaper that has paid subscribers, as distinguished from a "shopper" which is distributed free of charge, because they know that people who have a paid subscription to a newspaper are more likely to read it. A subscription list is therefore "an indispensable tool in selling advertising and is not simply a list but instead is used much as a machine to generate advertising revenue." *Id.* at 536. The Eighth Circuit observed that: "One of Donrey's experts testified that the value of the subscription list is related to this revenue enhancement—it is the present value of the difference in advertising revenues generated by the subscription list as compared to the revenues of an equivalent paper without a subscription list. *This value was thus characterized as being separate and apart from goodwill.*" *Id.* at 536 (emphasis added).

Donrey's evidence as to the business function and value of a newspaper subscription list is surely an "income approach," albeit one quite different from the "income approach" considered by the Third Circuit in this case. Yet, an "income approach" properly may be used to value any business asset because all business assets de-

rive their utility from the income they are expected to produce. See, *e.g.*, *Protective Comm.* v. *Anderson*, 390 U.S. 414, 442 (1968). As the Eighth Circuit understood in *Donrey*, newspaper subscription lists, like other business assets but unlike goodwill, have a "measureable value for a specific use": namely as a tool for generating additional advertising income. See *Citizens & S. Corp.* v. *Commissioner*, 91 T.C. 463, 516 (1988) (Cohen, J., concurring), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) (per curiam). This "measurable value," as well as their limited life, distinguishes them from goodwill.

ARGUMENT

THE COURT OF APPEALS ERRED IN HOLDING THAT NEWSPAPER SUBSCRIPTION LISTS WITH ASCERTAINABLE VALUES AND LIMITED USEFUL LIVES, THE DURATION OF WHICH HAS BEEN ESTIMATED WITH REASONABLE ACCURACY, MAY NOT BE DEPRECIATED AS A MATTER OF LAW.

In applying a definition of a nonstatutory term, "goodwill," to hold that newspaper subscription lists are not depreciable even though they are conceded to be valuable wasting assets with determinable useful lives, the Third Circuit strayed far afield from the congressional mandate laid down in Section 167(a) of the Internal Revenue Code. The decision below should therefore be reversed as inconsistent with the statute. However, even if the Court were to conclude that petitioner failed to prove that the subscription lists it acquired were depreciable assets, the Third Circuit's apparent conclusion that newspaper subscription lists are, as a matter of law, inseparable from goodwill when valued using an "income approach" is clearly incorrect and rests upon a fundamental misconception of the character, function and value of paid subscribers in the newspaper industry. Accordingly, any decision affirming the judgment of the court of appeals should be limited to the particular facts of this case.

A. The Third Circuit's Decision That A Valuable Wasting Asset May Not Be Depreciated Is Fundamentally Inconsistent With Section 167(a) Of The Internal Revenue Code.

The Third Circuit based its holding on a vague, general definition of the term "goodwill"—a term used in Treasury Regulation Section 1.167(a)-3, but not found in Section 167(a).[6] In the Third Circuit's view, the district court reached the wrong result not because of any specific flaw in its application of the statutory requirements to the facts at hand, but because it "applied the wrong definition of 'goodwill.'" *Id.* at 29a. *Amicus* submits that the Third Circuit's conclusion—that a concededly valuable wasting asset is nondepreciable—is contrary to the clear language of Section 167(a) of the Internal Revenue Code.

In language that has changed little since the Revenue Act of 1913, Section 167(a) of the Code provides for the depreciation of wasting assets:

> There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

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[6] Treas. Reg. § 1.167(a)-3 provides in pertinent part as follows:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. *No deduction for depreciation is allowable with respect to good will.*

Treas. Reg. § 1.167(a)-3 (as amended in 1960) (emphasis added).

26 U.S.C. § 167(a). See Revenue Act of 1913, Ch. 16, § II B, 38 Stat. 167; 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 23.1.1 (2d ed. 1989). The allowance for depreciation flows from the fundamental nature of our income tax: it is a tax on *net* income. Taxpayers are allowed to deduct from gross income the cost of producing that income. See 26 U.S.C. §§ 63, 161, 162 *et seq.*

One of the costs of producing income is the cost of wasting assets whose value is exhausted over the course of their useful lives. *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 101 (1943). "[I]t is the primary purpose of depreciation accounting to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use . . . of the asset to the periods to which it contributes." *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 104 (1960); *Northern Natural Gas Co.* v. *United States*, 470 F.2d 1107, 1109 (8th Cir.), *cert. denied*, 412 U.S. 939 (1973). Furthermore, Section 167(a) "does not distinguish between tangible and intangible assets and it says nothing by way of disqualifying an asset for depreciation merely because it is an intangible." *Northern Natural Gas Co.* v. *O'Malley*, 277 F.2d 128, 139 (8th Cir. 1960) (Blackmun, J., concurring). See Treas. Reg. § 1.167(a)-3 (as amended in 1960); *Griswold* v. *Commissioner*, 400 F.2d 427, 433 (5th Cir. 1968).

By the express terms of Section 167(a), a finding that the value of an asset will be exhausted over a useful life of reasonably ascertainable duration entitles the taxpayer to depreciation. See *Northern Natural Gas Co.*, 277 F.2d at 131; *Super Food Servs., Inc.* v. *United States*, 416 F.2d 1236, 1238 (7th Cir. 1969). Thus, in *Northern Natural Gas*, the Eighth Circuit relied upon Congress' use of the word "shall" in Section 167(a)'s predecessor:

> It is our belief that the statute authorizing the deduction is mandatory and not permissive, and requires the Commissioner to grant the deduction to a taxpayer who brings his claim within the provision of the statute.

Northern Natural Gas Co. v. *O'Malley*, 277 F.2d at 131-32.

The Third Circuit's conclusion that the "wasting asset" in question is not depreciable rests, not upon any analysis of the statutory language, but upon what the court believed to be the "proper definition of goodwill." Pet. App. 29a-30a. Although Congress never has declared that a wasting asset is not depreciable if it may be characterized as "goodwill," the concept of "goodwill" was introduced in an interpretive regulation—Treas. Reg. § 1.167(a)-3—issued by the Department of Treasury under Section 167(a). After providing that a depreciation deduction is allowed for intangible assets that are "of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy," the Treasury Regulation then declares that "[n]o deduction for depreciation is allowable with respect to good will." Treas. Reg. § 1.167(a)-3 (as amended in 1960); see *supra* p. 9 n.6.

Section 1.167(a)-3 was promulgated pursuant to the Treasury Department's general authority under Section 7805(a) of the Code to "prescribe all needful rules and regulations." Section 7805(a) is not a grant of substantive rulemaking authority or "a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision." *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982) (quoting *Rowan Cos.* v. *United States*, 452 U.S. 247, 253 (1981)). As an "interpretive" regulation, Section 1.167(a)-3 cannot establish more stringent conditions for depreciation of intangible assets than those imposed by the clear language of the statute. See *Northern Natural Gas Co.* v. *O'Malley*, 277 F.2d at 133-35.[7] It cannot take away a right clearly

[7] In *Northern Natural Gas*, the Eighth Circuit was addressing the counterpart to Treas. Reg. § 1.167(a)-3 under the Internal

granted by the statute; nor can it restrict or enlarge the scope of the statute. *Id.* at 134 ("[i]n interpreting a regulation, courts will ordinarily avoid a construction which raises doubt as to the validity of the regulation").[8]

The primary flaw in the decision below is that the court's interpretation of the term "goodwill," as used in the Treasury Regulation, is contrary to the mandate of Section 167(a). In essence, the Third Circuit has held that the proper scope of the regulatory term "goodwill" includes the "paid subscribers" acquired by petitioner even though, as valuable assets with limited useful lives of reasonably ascertainable duration, the "paid subscribers" unquestionably satisfy the statutory requirements for depreciability. Thus, assets that are *conceded* to have "wasting lives that can be estimated with reasonable accuracy," Pet. App. 29a, are deemed not to be depreciable for the sole reason that, in the Third Circuit's view, they come within the injunction—found in the Treasury Regulation but not in the statute—that "[n]o deduction for depreciation is allowable with respect to good will." *Id.* at 8a-9a. The Third Circuit's interpretation of the Treasury Regulation constitutes "an attempted addition to the statute of something which is not there," and therefore is invalid. See *United States* v. *Calamaro*, 354 U.S. 351, 358-59 (1957); *Vogel Fertilizer Co.*, 455 U.S. at 24-25; *Northern Natural Gas* v. *O'Malley*, 277 F.2d at 133-35. See also *INS* v. *Cardoza-Fonseca*, 480 U.S. 421, 446-448 (1987). This interpretation of the Treasury Regulation is neither necessary nor appropriate.

Revenue Code of 1939. The statute and regulation considered in *Northern Natural Gas* are substantially identical to their modern counterparts, now before this Court.

[8] *See also Steen* v. *Commissioner*, 508 F.2d 268, 270 (5th Cir. 1975) (per curiam) (also construing regulations under Section 167(a)); *Bhada* v. *Commissioner*, 89 T.C. 959, 972 (1987), *aff'd*, 892 F.2d 39 (6th Cir. 1989); *Graves* v. *Commissioner*, 88 T.C. 28, 33 (1987); *Apis Prods., Inc.* v. *Commissioner*, 86 T.C. 1192, 1205 (1986).

In determining what is goodwill, the analysis must instead be guided by the overarching mandate of Section 167(a) that a depreciation deduction "shall" be allowed with respect to a wasting asset. The interpretation of "goodwill" that is more faithful to the statute reflects the reason why goodwill is not depreciable. Thus, in *Houston Chronicle*, the Fifth Circuit stated that, in ascertaining whether an intangible asset is amortizable:

> [t]he precise issue is often whether or not the asset involved is either ordinary goodwill or so much like goodwill that the reasons for denying amortization deductions for goodwill are fully applicable. Foremost among those reasons is the conclusive presumption that goodwill is a nondepreciating capital asset. Viewed in a business context, the economic value of a taxpayer's continuing goodwill within his field of operations is seen as an ongoing asset that fluctuates but does not necessarily diminish. The crucial question becomes one of asking whether the intangible capital asset involved necessarily possesses similar characteristics.

Houston Chronicle, 481 F.2d 1240, 1247-48 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) (citations and footnote omitted). See also *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 454 (Ct. Cl. 1976) (per curiam) ("An intangible asset is separate and distinct from goodwill when its useful life can be shown with reasonable accuracy to be of limited duration."); *Colorado Nat'l Bankshares, Inc.* v. *Commissioner*, T.C.M. (P-H) ¶ 90,495, at 2397 (1990) ("[W]here the useful life of an intangible is shown to be limited, depreciation is available even though for some purposes it is an element of goodwill.").[9]

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[9] In the opinion below, the Third Circuit acknowledged the "analytical force" of the Tax Court's reasoning in *Colorado National*. Pet. App. 28a.

Properly understood, Treas. Reg. § 1.167(a)-3 interprets and applies the statute; it does not attempt to change it. Intangible assets that have limited useful lives are depreciable; depreciation is denied for assets with respect to which a limited useful life cannot be estimated with reasonable accuracy. Goodwill is not subject to depreciation because, by definition, it has an indefinite life and is self-regenerating. Accordingly, "[t]he most significant indication that an intangible asset is separate and distinct from goodwill is whether its useful life can be shown with reasonable accuracy to be of limited duration. The most important criterion is whether in fact it is a wasting asset." *Richard S. Miller & Sons, Inc.*, 537 F.2d at 452.

This understanding of the Treasury Regulation is consistent with its history. The sentence dealing with goodwill was added to the Treasury Regulation in substantially its current form in 1927. The Treasury Decision that amended the Treasury Regulation to add the sentence explained that the action was being taken "[i]n view of" the decision of the court of appeals in *Red Wing Malting Co.* v. *Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927). T.D. 4055, VI-2 C.B. 63 (1927). In that case, the Eighth Circuit held that goodwill was not property for which a deduction could be claimed under the predecessor to Section 167(a) because "[w]e are satisfied that there can be no wear or tear of good will, or exhaustion thereof by use, and . . . [the statute] limits the allowance for obsolescence to such property as is susceptible to exhaustion, wear, and tear by use in the business, and good will is not such property." *Red Wing Malting*, 15 F.2d at 633. It is thus clear that "goodwill," as viewed by the court in *Red Wing Malting* and as then incorporated into the Treasury Regulation, is an asset that by definition has an indefinite life and is not subject to wear and tear. It must follow that, if a valuable intangible asset has been proved to have a limited useful

life—to be wasting—it is not "goodwill" as that term is used in Treas. Reg. § 1.167(a)-3.[10]

In sum, Section 167(a) provides that wasting assets are depreciable. All agree, as the district court found, that the subscription lists acquired by petitioner are wasting assets. That should end the matter. The judgment of the court of appeals should be reversed.

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[10] In its brief in response to the petition for a writ of certiorari in this case, the Government points out that the sentence of the Treasury Regulation dealing with goodwill "has been carried forward essentially unchanged through repeated reenactments of the revenue laws and has now 'acquired the force of law' . . . ." (Resp. 9) (quoting *Cammarano* v. *United States*, 358 U.S. 498, 508-11 (1959)). But the sentence by itself, and as interpreted by the courts in *Houston Chronicle* and the cases following it, is unexceptionable. It is only the unique gloss placed on "goodwill" by the court of appeals in this case that creates any problem. Certainly Congress has not ratified the Third Circuit's analysis.

In any event, there is no basis for reading the Treasury Regulation in a manner inconsistent with the governing statute. *Cottage Sav. Ass'n* v. *Commissioner*, 111 S. Ct. 1503, 1509 (1991); *Public Employees Retirement Sys.* v. *Betts*, 492 U.S. 158, 171 (1989). The Treasury Regulation, including the injunction against depreciating goodwill, was promulgated to interpret a statute that, since 1913, has unambiguously mandated that a depreciation deduction "shall" be allowed for wasting assets. The Treasury Regulation must be read, today as in 1927, in a manner consistent with that statute. See *INS* v. *Cardoza-Fonseca*, 480 U.S. 421, 446-48 (1987); *NLRB* v. *United Food & Commercial Workers Union, Local 23*, 484 U.S. 112, 123 (1987); *Securities Indus. Ass'n* v. *Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 143 (1984). An interpretation of the Treasury Regulation which would deny depreciation with respect to a concededly wasting asset is manifestly inconsistent with Section 167(a) and, as discussed above, is neither necessary nor appropriate.

B. The Third Circuit Misunderstood The Nature And Function Of A Newspaper Subscription List And Erred In Determining That, As A Matter Of Law, The Income Approach To Valuing A Subscription List Fails To Produce A Value Separate And Apart From Goodwill.

Houston Chronicle and the cases following it have stated that the depreciability of an intangible asset is a question of fact and that a taxpayer is entitled to depreciate such an asset if he demonstrates that the asset has an ascertainable value separate and distinct from goodwill and a limited useful life, the duration of which can be estimated with reasonable accuracy. *Houston Chronicle*, 481 F.2d at 1251. See, *e.g.*, *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987) (newspaper subscription list); *Citizens & S. Corp.* v. *Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) (bank "deposit base") (per curiam); *Richard S. Miller & Sons, Inc.*, 537 F.2d 446 (insurance "expirations").[11]

The opinion below recognized that petitioner established that the acquired subscription lists have limited useful lives, the length of which can be estimated with reasonable accuracy, and ascertainable value. Pet. App. 9a. The court held, however, that the method used by petitioner to establish the value of the subscription lists failed, as a matter of law, to distinguish them from goodwill. As recounted by the Third Circuit, petitioner's experts valued the subscription lists by reference solely to the anticipated future stream of subscription revenue. Specifically, the expert witnesses first calculated the present value of the gross subscription revenue stream that would be generated by the subscribers over their estimated useful lives.

[11] The IRS itself has ruled that the purchaser of a publishing corporation may depreciate the acquired subscription contracts provided that the purchaser establishes that they have an ascertainable value separate and distinct from goodwill and a limited useful life, the duration of which can be ascertained with reasonable accuracy. Rev. Rul. 76-520, 1976-2 C.B. 42.

They then subtracted the projected cost of collecting that subscription revenue. Pet. App. 6a.

In the view of the Third Circuit, petitioner's experts had treated each subscription list as a customer list "to be valued as the stream of *income* to be generated by the listed customers over their remaining years of patronage." Pet. App. 29a. The court concluded, apparently as a matter of law, that "when employed in the context of the sale of an ongoing concern, the income approach to valuing a list of customers inherently includes much or all of the value of the expectancy that those customers will continue their patronage—*i.e.*, the goodwill of the acquired concern."[12] Pet. App. 30a.

For the reasons set forth earlier, *amicus* believes that the Third Circuit's approach to goodwill is fundamentally flawed. However, even if the evidence introduced by petitioner was not adequate to satisfy petitioner's burden of proving a value for the subscription lists separate and apart from goodwill, it would not follow that an income

[12] The Third Circuit discussed three cases as "demonstrat[ing] convincingly" that the rule it articulates is correct. Pet. App. 23a-26a. Those cases are *General Television, Inc.* v. *United States*, 449 F. Supp. 609 (D. Minn. 1977), *aff'd*, 598 F.2d 1148 (8th Cir. 1979) (per curiam); *Panichi* v. *United States*, 834 F.2d 300 (2d Cir. 1987) and *AmSouth Bancorporation* v. *United States*, 681 F. Supp. 698 (N.D. Ala. 1988). The Third Circuit acknowledged, however, "that the validity of *AmSouth* is questionable after the Eleventh Circuit's decision in *Citizens & Southern* . . . ." Pet. App. 27a. In *Donrey*, the Eighth Circuit stated authoritatively that *General Television* does not stand for the rule of law endorsed by the Third Circuit. *See Donrey, Inc.* v. *United States*, 809 F.2d 534, 537 (8th Cir. 1987). Finally, in *Panichi*, the Second Circuit affirmed the District Court's judgment that a purchased customer list, which had been valued at a multiple of monthly receipts from the customers on the list, could be amortized over a 15 year life. *Panichi*, 834 F.2d at 301. While the case did not involve the purchase of an entire business, it is clear that the customer list was valued based on the expected continuing patronage of the listed customers over the useful life of the list.

approach to valuation is incompatible with amortization as a matter of law.

In the *Donrey* case, an "income approach" was also used to value the acquired subscription list, but it differed substantially from the "income approach" considered by the Third Circuit. The extensive evidence Donrey introduced regarding the nature, function and use of the acquired subscription list led the Eighth Circuit to reach the following conclusions:

> There was evidence that 80% of the newspaper's gross revenues come from advertising, without which the newspaper would not be profitable. The advertising rates are determined by the number of persons on the subscription list. . . . . Advertisers use the list in order to evaluate how many persons will see their advertisements. Many of the nation's newspapers have their lists independently audited by the Audit Bureau of Circulation so that advertisers will have confidence in their accuracy.

Donrey, Inc., 809 F.2d at 535-36.

Based upon this evidence of the nature and use of a subscription list, the *Donrey* court found that Donrey was able to establish a value for the list as a *distinct* income-generating asset:

> There was testimony that a newspaper with a subscription list is substantially different from the 'shopper' type paper which is distributed free of charge. Advertisers are willing to pay more to place advertisements in newspapers with paid subscription lists than in shoppers because readers are more likely to read newspapers for which they have paid. There was also testimony that the *Times Herald* derived *additional revenue from advertisers as a result of the subscription list.* One of Donrey's experts testified that the value of the subscription list is related to this revenue enhancement—it is the present value of the difference in advertising revenues generated by the subscription list as compared to the revenues of an equivalent paper without a subscription list.

Donrey, Inc., 809 F.2d at 536 (emphasis added). The value of a subscription list as "an indispensable tool in selling advertising" was thus "characterized as being separate and apart from goodwill." *Id.* at 536.

The evidence before the Eighth Circuit showed that newspapers do, of course, receive revenue directly from subscribers, and subscription lists properly derive a portion of their value from anticipated subscription revenues. However, Donrey demonstrated that a newspaper subscription list is not primarily a list of customers and its value is not primarily related to the stream of future subscription revenues it represents. Instead, a newspaper's principal "customers" are its advertisers, not its subscribers. Because advertisers are willing to pay a premium to advertise in a newspaper that has paid subscribers, a newspaper subscription list has distinct importance as a "machine to generate advertising revenue," *i.e.*, a revenue-generating asset that has an ascertainable value and limited useful life.[13] *Donrey, Inc.*, 809 F.2d at 536.

Amicus is concerned that, although the evidence in *Donrey* regarding the nature and value of the acquired subscription list differed substantially from that considered by the court of appeals in this case,[14] the Third Cir-

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[13] The importance of this asset is reflected in the fact that newspapers have their subscription lists audited by an independent agency, the Audit Bureau of Circulation, so that advertisers will have confidence in the accuracy of the lists. *Donrey, Inc.*, 809 F.2d at 536.

[14] The eight newspapers involved in the instant case also derived "upwards of 80 percent of their total revenues from advertising fees." Pet. App. 6a n.2. Although the "preferred" valuation method used by petitioner's experts was based solely on expected subscription revenues, one of the experts confirmed the results of this "preferred" valuation by performing an alternative analysis based

cuit would appear to treat both as "income approaches" in the context of the acquisition of an ongoing concern and therefore to deny depreciation as a matter of law.[15] Moreover, the Third Circuit's limited view of the nature and function of subscription lists, based solely on the facts of this case, obviously contributed to its conclusion that an income approach to valuation of any subscription list inevitably will include goodwill.

The *Donrey* decision itself provides ample evidence that the Third Circuit has painted with an overly-broad brush. Moreover, the Third Circuit's rejection of an "income approach" to valuation of this particular asset overlooks the fact that such an approach may be used to value *any* business asset because all business assets derive their utility from the income they are expected to produce for the business over their useful lives. See S. Reed, *The Art of M & A* 64 (1989); R. Brealey & S. Myers, *Principles of Corporate Finance* chs. 2-6 (1984). As this Court has observed on a number of occasions, "the commercial value of property consists in the expectation of income from it . . . ." *Galveston, H. & S. A. Ry.* v. *State of Texas*, 210 U.S. 217, 226 (1908); *Protective Comm.* v. *Anderson*, 390 U.S. 414, 442 (1968). That income results from the patronage—and hopefully repeat patronage—of customers. Hence, the value of all business assets ultimately reflects "the probability that old customers will resort to the old place." Yet, it surely does not follow that all assets are goodwill and not depreciable.

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on "all revenues and costs." Pet. App. 46a. See Pet. App. 6a-7a n.2, 44a-45a. However, the Third Circuit clearly did not understand from that testimony or other evidence that subscription lists have a function and value in the newspaper business distinct from "customer lists."

[15] The Third Circuit rather clearly treats its decision as in conflict with *Donrey*, although it does not say so explicitly. (Pet. App. 19a).

This point was made forcefully by Judge Cohen in her concurring opinion in the *Citizens and Southern* case:

> I have found . . . no authority for the proposition that assets, intangible or tangible, are not separate and distinct from goodwill unless no part of their value is related to continued patronage of customers of an ongoing business. . . . [A]ssets are frequently found to be eligible for amortization even though the price paid took into account the probable continuance of terminable business relationships. Tangible property, such as special purpose equipment, is unquestionably subject to depreciation even though its value may be enhanced by its use in an ongoing business. It seems to me that the requirement that an asset be separate and distinct *means only that it must have a measurable value for a specific use.*

Citizens & S. Corp. v. *Commissioner*, 91 T.C. 463, 515-16 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990) (per curiam) (citations omitted) (emphasis added). Based on the evidence introduced by Donrey, the Eighth Circuit understood that a newspaper subscription list has "a measurable value for a specific use": namely as a tool for generating additional advertising revenue. Numerous other courts have reached similar conclusions with respect to similar intangible assets.[16]

These cases confirm that the determination of whether an asset is depreciable—*i.e.*, whether the two prongs of the *Houston Chronicle* test are satisfied—is inherently factual. The Third Circuit's attempt to formulate a rule

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[16] *See, e.g., Commissioner* v. *Seaboard Fin. Co.*, 367 F.2d 646, 651 (9th Cir. 1966); *IT & S of Iowa, Inc.* v. *Commissioner*, 97 Tax Ct. Rep. (CCH) No. 34 at 4556-57 (1991); *Los Angeles Cent. Animal Hosp., Inc.* v. *Commissioner*, 68 T.C. 269, 274 (1977), *acq.*, 1978-2 C.B. 2; *Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223, 225, 232-37 (1975), *acq.*, 1976-2 C.B. 1; *Manhattan Co.* v. *Commissioner*, 50 T.C. 78, 91, 93 (1968), *acq.*, 1974-2 C.B. 3; *Business Servs. Indus.* v. *Commissioner*, T.C.M. (P-H) ¶ 86,086, at 338 (1986).

that income-based valuations of newspaper subscription lists are, as a matter of law, inherently inseparable from goodwill should be rejected.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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No. 91-1135

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY,
Petitioner,

v.

THE UNITED STATES OF AMERICA,
Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

---

BRIEF OF INDEPENDENT INSURANCE AGENTS OF AMERICA, NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS, NATIONAL ASSOCIATION OF INSURANCE BROKERS, NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS, THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS, AND THE COALITION OF INDEPENDENT CASUALTY COMPANIES OF AMERICA, AS AMICI CURIAE, IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether customer-based intangibles with a limited useful life and an ascertainable value are nondepreciable goodwill.

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INTRODUCTION

This brief is filed on behalf of the Independent Insurance Agents of America, the National Association

of Casualty & Surety Agents, the National Association of Insurance Brokers, the National Association of Professional Insurance Agents, the National Association of Independent Insurers, and the Coalition of Independent Casualty Companies of America (the "Amici"), to urge this Court to reverse the judgment of the Third Circuit. The written consents of the parties to the filing of this brief have been filed with the Clerk of the Court.

THE AMICI

Independent Insurance Agents of America is the nation's largest independent insurance agent association, representing over 220,000 independent agents and their employees. Its members offer all lines of insurance, including property, casualty, life, and health insurance.

The National Association of Casualty & Surety Agents represents 300 of the nation's largest property and casualty insurance agencies and brokerages specializing in the sale and service of commercial insurance products to business, industry and municipalities.

The National Association of Insurance Brokers ("NAIB") is the national trade association of commercial insurance brokers. Founded in 1934, its members range in size from large international companies to regional and local firms. NAIB members represent clients in the United States and around the world. NAIB members administer the majority of coverage in the $110 billion commercial property and casualty insurance market in the United States.

The National Association of Professional Insurance Agents ("PIA") is a nonprofit trade association, representing 180,000 independent insurance agents and their employees who sell and service all lines of insurance, specializing in coverage for homes, autos and business. PIA is represented throughout the United States and Puerto Rico by members affiliated with forty-one PIA state or regional associations.

The National Association of Independent Insurers is a non-profit trade group representing the interests of over 500 property and casualty insurance companies in the United States.

The Coalition of Independent Casualty Companies of America is an association of small property and casualty insurance companies with members located in over thirty-five states and the District of Columbia.

THE INTERESTS OF THE AMICI IN THIS CASE

This case presents the issue of whether terminable-at-will customer relationships acquired by purchase are subject to the allowance for depreciation provided in section 167 of the Internal Revenue Code ("Code"), when they are acquired as part of an ongoing business. The outcome of this case could directly affect the value of the business assets of the Amici's members.

Numerous members of the Amici have, in the course of their trades or businesses, either purchased or sold intangible assets, including customer-based intangible assets. In fact, the bulk of the value of their businesses often consists of customer-based intangible assets, such as insurance expirations.

Many members of the Amici have been assessed additional tax or are the subject of adjustments proposed by the Internal Revenue Service (or may be in

the future), because they depreciate the cost of various intangible assets that they purchase. The Internal Revenue Service has often taken the position that insurance expirations and other insurance business intangible assets are in the nature of goodwill, and, therefore, are nonamortizable. The Service has prevailed in some cases, and taxpayers have prevailed in others. *See, e.g., Marsh & McLennan, Inc. v. Commissioner*, 420 F.2d 667 (3d Cir. 1969); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446 (Ct. Cl. 1976); *Robbins & Weill, Inc. v. United States*, 382 F. Supp. 1207 (M.D.N.C. 1974).

SUMMARY OF THE CASE

The issue in this case is whether a depreciation deduction under Code section 167 is available for the portion of the purchase price of eight Michigan newspapers purchased by Newark Morning Ledger Co. ("Morning Ledger") that was allocable to individually-identified, periodically-paying subscribers, each having terminable-at-will contracts for delivery of daily and/or Sunday editions of the respective newspapers.

To prevail on its claim, Morning Ledger had to prove that the subscriber relationships had: (1) an ascertainable value separate and distinct from goodwill; and (2) a limited useful life that could be estimated with reasonable accuracy. Pet. App. at 9a.[1]

The Third Circuit accepted the district court's finding that the Morning Ledger newspaper subscriptions had: (1) wasting lives that can be estimated with reasonable accuracy, and (2) ascertainable values. However, the Third Circuit held that the subscription contracts, because they were acquired as part of an ongoing business, were not "separate and distinct from goodwill," and accordingly were not depreciable.

[1] References are to pages of the Appendix to the Petition for a Writ of Certiorari.

In arriving at its conclusion, the Third Circuit viewed the issue before it as turning on the proper definition of "goodwill" and it accepted the formulation arguably found in one body of case law opinions: *i.e.*, that goodwill is "the expectation of continued patronage." On that basis, because "the projected stream of income to be generated by the 460,000 at-will subscribers is simply a quantification of Morning Ledger's expectation that these subscribers will continue their patronage," (Pet. App. at 11a), the Third Circuit held that Morning Ledger's newspaper subscription contracts were nondepreciable goodwill, notwithstanding that they have wasting lives that could be estimated with reasonable accuracy, and ascertainable values. The court further held that its view of goodwill as "the expectation of continued patronage" precluded the utilization of the residual method to determine goodwill and also precluded the utilization of the capitalized income stream method to value the subscription contracts.

SUMMARY OF ARGUMENT

The Third Circuit's definition of goodwill effectively creates a presumption, which is intended to be virtually impossible to refute, that all customer-based intangibles, acquired as part of an ongoing business, are themselves inherently part of goodwill and, therefore, nondepreciable. The Third Circuit reached its conclusion without analysis or concern as to why goodwill is treated as nondepreciable for income tax

purposes. The Third Circuit's position is inconsistent with fundamental historic federal income tax principles; illogical because it would provide radically different tax treatment for identical assets depending on whether such assets are acquired separately or as part of an ongoing business; contrary to existing case law; and wholly inconsistent with both Congressional action and inaction in this area.

Fundamental principles of tax policy require the matching of expenses to revenues for the taxable period to which the items are properly attributable. Denying a depreciation deduction for the cost of acquiring an asset with an ascertainable value and determinable useful life results in an inaccurate measurement of a taxpayer's taxable income, which would cause taxable income to exceed the taxpayer's net economic income. Therefore, the definition of goodwill should be drawn to exclude intangible assets with ascertainable values and with limited useful lives.

The Third Circuit incorrectly concluded that Congress has "stood mute" regarding the definition of goodwill. Recent legislative actions by Congress, in enacting section 1060 of the Code and in declining to enact legislation broadening the tax definition of goodwill to include customer-based intangibles, confirm that goodwill should be defined to exclude intangible assets with ascertainable values and with limited useful lives.

ARGUMENT

1. The Third Circuit's Expansive Definition of Goodwill Would Likely Serve to Preclude the Amici's Members from Offering Proof to Establish that Customer-Based Intangibles Purchased as Part of an Ongoing Insurance Business Have Characteristics Separate and Distinct From Non-Amortizable Goodwill.

The Third Circuit attempts, in effect, to create a presumption that all customer-based intangibles acquired as part of an ongoing business are inherently part of goodwill. Under the Third Circuit's standard, "for tax purposes, there are some intangible assets which, notwithstanding that they have wasting assets that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." Pet. App. at 29a. Thus, the Third Circuit concluded, "it is virtually impossible for the taxpayer to disentangle the potentially depreciable value of [customer-based intangibles] from the value of the nondepreciable goodwill," (Pet. App. at 17a) and, "it is simply often too difficult for the taxpayer and the court to separate the value of the [customer] list *qua* list from the goodwill value of the customer relationships/structure." Pet. App. at 29a.

Such a view is reminiscent of the "mass asset rule" discredited more than 18 years ago in *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974),[2]

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[2] The Third Circuit, explaining the mass asset rule, stated:

> Until 1973, the Service successfully had persuaded the courts that documentary evidence of customer structure, such as a customer list, was generally sufficiently intertwined with goodwill, if not goodwill itself, so as

and should not be applied to intangibles such as insurance expirations, workforce-in-place, information base, licenses and permits, and other intangible assets essential to the insurance industry. Such a view is not consistent with economic reality, because each year, in numerous business acquisitions of insurance brokerages, agencies and insurance companies, members of the Amici do in fact establish the values and useful lives of such intangibles, separate and distinct from goodwill.

For instance, the Amici have particular expertise with respect to the values and useful lives of the customer-based intangibles that are part of an insurance brokerage business. Insurance brokers and agents recommend, place and service insurance and risk management programs on behalf of businesses, organizations, governmental agencies and individuals. Commercial insurance brokers and agents identify and define risks of their clients (e.g., property, general liability, environmental, marine and transportation risks) and locate insurance markets to provide insurance coverage.

The relevant information regarding each client that is maintained by insurance brokers and agents is known in the industry as insurance expirations. The information contained in insurance expirations will usually consist of a customer's name, address, and the nature of his insurance coverage with the agency, including the name of the carriers, the type and number of lines, the expiration and renewal dates, pre-

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to render depreciation inappropriate as a rule of thumb.

Pet. App. at 14a.

mium amount and schedules, payment ledgers, reports and a summary of policy terms. For commercial clients, insurance expirations may also describe the manner in which a customer's property and business operations have been rated or classified for insurance purposes, the rights of the insurance company to audit customer compliance with the terms of the policy, and the method of premium payment. Thus, an insurance expiration can be a detailed insurance profile of the customer and the insurance needs of a business.

An insurance broker or agent with the information that comprises the insurance expiration can generally outperform its competition with respect to that client and therefore has a significant competitive advantage.

Just as with tangible assets, insurance expirations are bought and sold in transactions separate from the acquisition of an entire business. They have also been used as collateral in commercial transactions, and lenders have perfected security interests under the Uniform Commercial Code on insurance expirations.

The insurance industry recognizes that insurance expirations have a limited useful life. The information becomes obsolete over a period of time. Factors influencing the obsolescence of insurance expirations include price competition on premiums and fees charged for coverage, changes in a client's risk management personnel and philosophy, competitors' efforts to convince a client that it can better serve the client's insurance brokerage and risk management needs, and changes in the risk management needs of the client

due to mergers, liquidations, expansion, contractions, as well as other factors.[3]

Similarly, members of the Amici are able to determine the values and useful lives of other intangible assets, such as workforce-in-place, covenants not to sue, licenses and permits, etc. that are often part of a particular insurance business. However, under the Third Circuit's erroneous view of the nature of such assets, the Amici members' ability to establish the separate values and useful lives of such intangible assets would no longer be determinative on the issue of depreciability.

2. The Third Circuit Decision is Fundamentally At Odds with the Basic Tax Policy Objective of Matching Income and Expense and With the Net Income Nature of Our Federal Income Tax System.

As an economic matter, the purchaser of an ongoing business with stable, existing customer relationships expects to earn a quantifiable income stream from those existing customer accounts, and can project with reasonable certainty the average expected remaining useful life of those specific, identifiable customer accounts. The purchase price for the business invariably takes into account these customer relationships and the associated projected income stream, just as the purchase price takes into account the value of tangible personal property.

The purpose of depreciation and amortization deductions is to facilitate the proper reporting of taxable income on a net income basis, by permitting taxpayers to offset the costs of capital expenditures for wasting

[3] The Appendix to this brief contains a detailed description of the characteristics of insurance expirations.

assets against the income generated by those assets. *See generally* Treasury Regulations sections 1.167(a)-1 and 1.167(a)-3. Through such provisions, the Code "endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." *INDOPCO, Inc. v. United States*, 112 S. Ct. 1039, 1043 (1992). *See also Massey Motors v. United States*, 364 U.S. 92, 96 (1960). To the extent a taxpayer is prevented from recovering through depreciation the cost of a wasting asset with an ascertainable value, the taxpayer's taxable income is overstated, and the taxpayer is subjected to a tax in excess of what the tax would be on the taxpayer's net economic income.

As a matter of sound tax policy, then, a taxpayer should be entitled to amortize its acquisition cost for customer-based intangible assets, regardless of whether or not they are acquired as part of an ongoing business, if the taxpayer can factually demonstrate that these assets have a limited useful life, the duration of which can be estimated with reasonable accuracy, and thus an ascertainable value separate and distinct from goodwill. Therefore, the tax definition of goodwill should be drawn to exclude intangible assets with ascertainable values and limited lives.

A careful review of the apparent historic basis for the prohibition against the amortization of goodwill suggests that the definition of goodwill for tax purposes should be narrowly construed. The current prohibition against the amortization of goodwill originally appeared as a 1927 amendment to Article 163 of Treasury Regulation 69. That amendment appears to have been in direct response to then-pending litigation

with respect to whether a decline in the value of goodwill of a brewery attributable to the onset of Prohibition justified a deduction for such loss in value. In that litigation this Court, overruling a Second Circuit decision to the contrary,[4] ultimately held that goodwill was not amortizable in such a situation. *Clarke v. Haberle Crystal Springs Brewing Co.*, 280 U.S. 384 (1930). The Court's decision clearly was strongly influenced by the narrow and historically unique non-tax policy consideration that goodwill associated with the production of alcohol was involved.

Many courts have concluded that depreciation is not allowable for goodwill because the useful life of goodwill is indeterminable. Thus, as courts have stated, for tax purposes, goodwill is, by definition, an intangible asset that has an indefinite life. *See, e.g., Richard S. Miller & Sons, Inc., supra*; *Colorado National Bankshares v. Commissioner*, 60 T.C.M. 771, 789 (1990).

Considering the basic tax policy objective of accurately measuring net income, sound tax policy would argue strongly in favor of narrowly, rather than broadly, construing the definition of goodwill. At a minimum, those considerations suggest that a taxpayer should have the ability to amortize assets that it has proved have a determinable value and useful life and are thus separable from goodwill.

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[4] *Haberle Crystal Springs Brewing Co. v. Clarke*, 30 F.2d 219 (2d Cir. 1929).

3. The Distinction Adopted by the Third Circuit Between Customer-Based Intangible Assets Separately Purchased and those Acquired as Part of an Ongoing Business is Illogical, and Inconsistent with the Fundamental Tax Policy Objective of Horizontal Equity.

As a business matter, customer-based intangibles—such as newspaper subscription lists, insurance expirations and existing customer accounts—*can be and are* purchased separately from ongoing businesses. The Third Circuit recognized that, when such assets are purchased separately, they may properly be amortized for federal income tax purposes. It is illogical to conclude that somehow such assets lose their separate identity and become unamortizable goodwill, if they are purchased as part of an ongoing business. Rather, as *Houston Chronicle* observed, "[o]ur view—that amortizability for tax purposes must turn on factual bases—is more in accord with the realities of modern business technology in a day when lists are bartered and sold as discrete vendible assets." 481 F.2d at 1253.

The Third Circuit's position also unfairly discriminates against taxpayers who purchase intangible assets as part of an entire business. Another tenet of the federal income tax system is that, as far as possible, similarly situated taxpayers should pay the same tax. *Commissioner v. Idaho Power Company*, 418 U.S. 1, 14 (1974). The objective of that fundamental policy of "horizontal equity" is to have persons with equal economic incomes pay the same amount of taxes. The Third Circuit's position is not consistent with the goal of horizontal equity. The Third Circuit would allow taxpayers who purchase intangible assets in separate transactions to depreciate their cost, but would prevent other taxpayers from recovering the cost of iden-

tical intangible assets having the same determinable value and the same ascertainable useful life, if purchased as part of an entire business. Allowing depreciation deductions to the first set of taxpayers, while preventing the second set of taxpayers from recovering their costs through depreciation deductions, is wholly inconsistent with sound tax policy.

If the Third Circuit's position stands, it is likely that a two-tiered valuation system will develop for customer-based intangible assets that will place an unwarranted premium on the form an acquisition takes. Assets such as insurance expirations, purchased separately from a trade or business, whose cost is depreciable for tax purposes, will carry a higher value than the same assets purchased as part of an ongoing business, which carry the tax "penalty" of nondepreciability. Under this two-tiered system, those taxpayers who, because of economic circumstances or other reasons, need to sell their entire businesses, would experience a diminution in the value of their business assets. That diminution is estimated at between 12% and 20% as compared with the value the businesses would have if those assets were clearly amortizable.

4. The Third Circuit's Decision Fundamentally Misinterprets Existing Case Law.

The cases relied on by the Third Circuit for the traditional definition of goodwill as "expectancy of continued patronage" fall into three categories: (a) old cases that apply the now-repudiated "mass asset rule;"[5] (b) cases that hold that the depreciability of

[5] Indeed, the Third Circuit's line of reasoning to the effect that "goodwill = expectancy of continued patronage = customer lists = goodwill," is virtually indistinguishable from the quintessential articulation of the discredited and repudiated "mass-asset rule" contained in *Golden State Towel and Linen Service, Ltd. v. United States*, 373 F.2d 938, 942-44 (Ct. Cl. 1967).

specific intangible assets, acquired as part of an ongoing business, depends on the factual criteria described above, but conclude on the facts of the particular case that the taxpayer failed to carry its burden of proof; and (c) cases in which the taxpayer carried its burden of proof and was entitled to depreciate the intangible asset in question. Thus, prior to the Third Circuit's decision, numerous courts saw no inconsistency between the traditional definition of goodwill and the allowance of a depreciation deduction for discrete customer-based intangibles acquired as part of an ongoing business, *if* the taxpayer met its burden of proof as a factual matter. Undoubtedly they recognized, as did the district court in *Newark Morning Ledger*, that "one must distinguish between a galaxy of customers who may or may not return, whose frequency is unknown, and whose quantity and future purchases cannot be predicted, against subscribers who can be predicted to purchase the same item, for the same price on a daily basis." Pet. App. at 32a-33a. *See also Citizens & Southern Corp. v. Commissioner*, 91 T.C. 466, 499 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990); *Super Food Services Inc. v. United States*, *supra*, 416 F.2d at 1239; *Computing & Software Inc. v. Commissioner*, 64 T.C. 223, 233 (1975); and *Los Angeles Central Animal Hospital, Inc. v. Commissioner*, 68 T.C. 269, 273-274 (1977).

In summary, the Third Circuit's decision ignores the case law precedent that terminable-at-will customer relationships may in fact properly be amortized for tax purposes, particularly in view of "the realities

of modern business technology in a day when lists are bartered and sold as discrete vendible assets." *Houston Chronicle, supra*, 481 F.2d at 1253. Thus, for example, the Seventh Circuit stated in *Super Food Services, Inc.*, 416 F.2d 1236 (7th Cir. 1969):

> It is immaterial that the contracts may have no fixed termination date. [citations omitted] In our view, . . . it is also immaterial whether these [terminable-at-will] contracts were acquired separately or as part of a going business. Any quarrel with the going concern value of contracts acquired as part of a business is properly directed to the allocation to be made between goodwill and the contracts purchased and should not be relied on as requiring a complete denial of the depreciation deduction to contracts shown to have a limited useful life.

416 F.2d at 1240.

Similarly, in *Citizens & Southern, supra*, the Tax Court stated:

> The fact that a deposit account has no fixed termination date and is terminable at will does not as a matter of law prevent petitioner from factually showing that deposit base has an ascertainable cost basis separate and distinct from goodwill and that it has a reasonably ascertainable useful life. [citations omitted] We emphasize the factual nature of our inquiry.

91 T.C. at 48.

In the current case, the parties stipulated the useful lives of the assets in question and Morning Ledger

introduced substantial, uncontroverted evidence that such assets were separate and distinct from goodwill. The district court rendered its decision based on its factual findings in favor of the taxpayer. Only by misconstruing applicable law was the Third Circuit able to override the district court's decision.

5. The Third Circuit's Apparent Rejection of the Residual Valuation Method for Determining Goodwill and the Income Forecast Method Is Erroneous.

The Third Circuit erroneously asserts that current law prevents a taxpayer from utilizing the residual method for separating customer-based intangibles from goodwill and limits a taxpayer to the cost method of valuing customer-based intangibles. Both assertions are erroneous.

Congress not only has approved the use of the residual method to value goodwill separately from intangibles, but in fact has mandated such treatment. Under Code sections 1060 and 338,as well as Treasury Regulations section 1.338(b)-2T(b), such treatment is required when allocating consideration to the basis of acquired assets. Moreover, case law prior to sections 332 and 1060 (including a Third Circuit decision) also applied the residual method to determine goodwill in appropriate circumstances.[6]

Furthermore, Congress in 1987 specifically declined to legislate that customer-based intangibles have to

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[6] *See, e.g., Jack Daniel Distillery v. U.S.*, 379 F.2d 569, 579 (Ct. Cl. 1967); *R.M. Smith, Inc. v. Commissioner*, 69 T.C. 317, 320-323 (1977), *aff'd*, 591 F.2d 248 (3d Cir.). *cert. denied*, 444 U.S. 829 (1979). The residual method has generally been viewed as more favorable to the government than alternative methods because it generally results in a greater amount of goodwill. *See generally Philip Morris, Inc. v. Commissioner*, 96 T.C. 660 (1991).

be treated as nondepreciable intangible assets with indeterminate useful lives. Section 10120 of H.R. 3545, the Revenue Bill of 1987, would have treated customer-based and similar intangibles as having an indeterminate useful life. Section 10120 was dropped by the conference committee prior to the enactment of H.R. 3545, as Title X of the Omnibus Budget Reconciliation Act of 1987.[7]

Regarding valuation methods, Congress, in the course of enacting Code section 1060, explicitly recognized that the income stream or capitalization of earnings method of determining fair market value is one of the "commonly accepted methods" of asset valuation for purposes of determining the tax basis of assets in the context of the acquisition of an ongoing business.[8]

Moreover, in addition to the erroneous nature of the Third Circuit's assertion that the income stream method is impermissible, the court's acceptance of the cost method is wholly inconsistent with the factual determination of the lower court concerning the Internal Revenue Service's cost basis valuation:

> In response to the expert opinions submitted by plaintiff, defendants offered experts

[7] Congress is currently considering H.R. 1456, the "Intangibles Amortization Clarification Act of 1991," that would clarify that customer-based intangibles are amortizable under current law. H.R. 1456 is co-sponsored by over 190 members of the Ho of Representatives. Its companion bill in the Senate, S. 1245, has 9 co-sponsors.

[8] S. Rpt. No. 99-313, 99th Cong. 2nd Sess. p. 252. *See also General Explanation of the Tax Reform Act of 1986* (Committee Print, 1987) at 356 (explaining the status of the law prior to enactment of section 1060).

> who were unqualified, valued the wrong asset and utilized inappropriate methodology.

Pet. App. at 43a.

It is particularly important to emphasize the district court's determination that the Internal Revenue Service's experts valued the "wrong asset," because it underscores the deficiencies of applying the cost method to these types of assets. The application of the cost method assumes that the cost of separately generating these customer-based intangibles occurs in a vacuum, *i.e.*, it begins from the assumption that the customer pool one is attempting to assemble is not already committed to another service provider. This is rarely the case. As a result, use of a cost method in the manner advocated by the Internal Revenue Service would rarely reflect economic reality.

CONCLUSION

The Amici respectfully urge that the Court reverse the Third Circuit.

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APPENDIX

APPENDIX

A. Productive Nature of Insurance Expiration Assets

Commercial insurance brokers recommend, place and service insurance and risk management programs on behalf of businesses, organizations, governmental agencies and individuals. Commercial insurance brokers are typically engaged to identify and define risks (e.g., property, general liability, environmental, marine and transportation risks) and locate insurance markets to provide insurance coverage.

The information that comprises the customer-based intangible asset known as Insurance Expirations is the quintessential asset of an insurance broker's business. The exclusive information that comprises the Insurance Expiration asset allows insurance brokers to reliably and efficiently generate revenue. The Insurance Expiration asset has been defined to consist of the following:

> [I]nformation relating to a customer's name, address, and the nature of his insurance coverage with the agency, i.e., name of the carrier(s), type and number of lines, expiration (renewal) dates, premium amounts and schedules, payment ledgers, reports, and a summary of policy terms.[1]

Among other uses, Insurance Expirations are used by brokers and agents to timely renew and adjust a client's insurance coverage.[2] The information that comprises the Insurance Expiration asset allows insurance brokers to timely evaluate (i) whether a client should continue to insure or self-insure its risks, (ii) whether a client can reduce its cost or increase the services its receives (such as claims handling) by obtaining coverage from a different insurance carrier or (iii) whether a change in a client's business (e.g.,

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[1] *Robins & Weill, Inc. v. U.S.*, 382 F. Supp. 1207 (M.D.N.C. 1974).

[2] *Richard S. Miller & Sons, Inc. v. U.S.*, 537 F.2d 446 (Ct.Cl. 1976).

exposure to new risks) requires enhancements to existing insurance coverage or new coverage altogether. In addition to enabling timely renewal and adjustment of coverage, Insurance Expiration information allows insurance brokers to provide other quality risk management services including (i) comparing a client's coverage with coverage provided to others with similar risks, (ii) recommending other risk management and related services to clients and (iii) developing and marketing "group" insurance programs for clients that share similar risks and require similar insurance protection. Simply stated, the insurance broker or agent that possesses the information that comprises the Insurance Expiration asset has a significant competitive advantage and can generally outperform its competition with respect to that client.

Due to the confidential nature of the Insurance Expiration asset, insurance brokers and agents will generally institute procedures within their firms to help assure that employees, former employees, co-brokers, insurers and competitors are not able to obtain and misuse the Insurance Expiration asset for their own commercial gain. When such assets are misused by employees, former employees or co-brokers or are unfairly obtained by competitors, the courts have recognized the commercial value of Insurance Expirations and have enforced the terms of agreements protecting the confidential nature of such assets, or enforced common law contract and fiduciary standards to protect the rightful owner of the asset.[3] Disputes regarding

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[3] *Alexander & Alexander Inc. v. Van Impe*, 787 F.2d 163 (3rd Cir. 1986); *Alexander & Alexander Benefits Services Inc. v. Benefits Brokers & Consultants. Inc.*, 756 F. Supp. 1408 D. Ore. 1991);*Alexander & Alexander Inc. v. Drayton*, 378 F. Supp. 824 (E.D. Pa. 1974); *Alexander & Alexander Inc. v. Danahy*, 488 N.E. 2nd 22 (Mass. Ct. App. 1986), *Alexander & Alexander Services Inc. v. Frederick Reed, et al.*, No. 84 CH 9844 (Cook County, Ill. Cir. Ct. 1986). The Uniform Trade Secrets Act has been enacted in over a dozen states. It generally codifies existing common law principles protecting an employer's confidential

the ownership or use of Insurance Expirations are often settled without the necessity of litigation. Such settlements have required the return of the Insurance Expiration asset to the broker claiming exclusive ownership, enjoining the wrongful taker from the future use of the asset or compensating the rightful owner equal to the value of the asset.

In addition to the courts, the insurance brokerage industry and insurance carriers recognize an insurance broker's exclusive ownership rights to its Insurance Expirations. In agency agreements between an insurance broker and an insurance carrier, the insurance broker is recognized as the owner of the Insurance Expirations although the insurance carrier can seize the Insurance Expiration pursuant to the agency agreement if the insurance broker is delinquent in remitting premiums. In other words, the agency agreement treats the Insurance Expiration asset as collateral for the insurance broker's obligation to remit premiums to the carrier.

Similar to tangible assets, Insurance Expirations are bought and sold among insurance brokers in separate transactions.[4] (Goodwill, on the other hand, is incapable of being separately bought and sold.[5]) A market for Insurance Expirations exists because, as indicated above, ownership of Insurance Expirations affords insurance brokers a com-

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information about its clients and customers. The case *Alexander & Alexander Benefits Services. Inc. v. Benefits Brokers & Consultants, Inc., supra*, holds that an insurance broker's confidential information about its clients' renewal dates, losses and risk characteristics were trade secrets under the Oregon Uniform Trade Secrets Act, and thus entitled to the protection afforded by that act.

[4] The U.S. Court of Claims in *Richard S. Miller & Sons, supra*, acknowledged the insurance expirations can be sold in discrete transactions.

[5] *Dodge Brothers Inc. v. U.S.*, 118 F.2d 95 (4th Cir. 1941) citing *Metropolitan National Bank v. St. Louis Dispatch Co.*, 149 U.S. 436 (S.C. 1893).

petitive advantage and because some brokers that specialize in providing particular types of insurance often desire to acquire Insurance Expirations within their specialty. Conversely, brokers that do not desire to specialize will often sell acquired or developed Insurance Expirations that require specialized knowledge.

Since Insurance Expirations have recognized commercial value, they have been used as collateral in commercial transactions. Additionally, security interests have been perfected under the Uniform Commercial Code when Insurance Expirations have been sold and full payment has not been received at the time of sale.

The accounting profession recognizes that Insurance Expirations are a separate asset that constitutes the major portion of the cost associated with the acquisition of an insurance broker.[6] The accounting profession has acknowledged that Insurance Expirations are an "identifiable" asset that is distinguishable from goodwill. Generally accepted accounting principles ("GAAP") and the tax law are similar in that intangible assets must be identified, valued and amortized over their estimated useful lives. GAAP requires an allocation of fair market value to intangible assets to insure that expenses are not understated and are properly matched with revenue.[7]

Other governmental agencies have also recognized the existence of the Insurance Expiration asset and issued guidelines regarding the method to value such assets. For example, the Federal Home Loan Bank Board has issued specific valuation guidelines regarding the method to properly value Insurance Expirations so as to provide standards to produce satisfactory evidence to support the purchase price of insurance agencies and brokers.[8]

[6] Insurance Agents and Brokers Task Force of the Insurance Companies Committee, Accounting Standards Division, American Institute of Certified Public Accountants, *Exposure Draft Proposed Industry Accounting Guide. Insurance Agents and Brokers*, par. 8.4, August 15, 1991.

[7] Accounting Principles Board Opinion 16, "Business Combinations" and Accounting Principles Board Opinion 17, "Intangible Assets."

B. Insurance Expirations Have a Limited Useful Life

Common sense indicates that the information that comprises the Insurance Expiration asset has a limited useful life since that information will become obsolete over a period of time. Factors that influence the obsolescence of Insurance Expirations include: (i) price competition on premiums and fees charged for coverage; (ii) changes in the client's risk management personnel and philosophy; (iii) competitors' efforts to convince a client that it can better serve that client's insurance brokerage and risk management needs and (iv) changes in the risk management needs of a client due to, among other reasons, mergers, liquidations, expansion, contraction or discontinuance of lines of business, changes in governmental regulations and standards, litigation hazards and changes in insurance carriers' willingness and ability to provide insurance coverage.

Insurance industry statistics indicate that an average Insurance Expiration has a useful life of seven years.[9] However, actual useful lives will vary depending on type of coverage, amount of commission, insurance broker practices and procedures to protect the asset, competitors' efforts and local economic factors.

[8] FHLBB #R-28 Memorandum Series, #R 28b (April 1976). The purpose of the FHLBB guidelines is to provide support for a loan since lenders attempt to avoid making loans that exceed the value of the assets acquired by borrowers.

[9] *Vaaler Insurance Inc. v. U.S.*, 68-1 USTC ¶ 9183, at 86,284 (D.N.D. 1968).

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No. 91-1135

In the Supreme Court of the United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA,
RESPONDENT.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the Petitioner Newark Morning Ledger Co. satisfied its burden of demonstrating to the trier of fact that certain newspaper subs ·ription lists it purchased in the acquisition of Booth Newspapers, Inc. were depreciable assets separate from goodwill.

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In the Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-1135

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA,
RESPONDENT.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF AMICUS CURIAE

The Investment Counsel Association of America, Inc. ("ICAA") respectfully submits this brief as amicus curiae in support of the petitioner. The signed consents of the parties are filed with this brief.

The ICAA is a national professional association of investment advisory firms. The ICAA comprises more than 160 investment advisory firms that collectively manage client assets in excess of $410 billion. All ICAA members qualify to use the term "investment counsel" under Section 208(C) of the Investment Advisers Act of 1940, which restricts the use of this term to

firms whose principal business consists of acting as investment advisers and a substantial part of whose activities consists of providing investment management services to clients.

The principal business assets of a typical ICAA member organization are the investment advisory contracts which the firm enters into with its customers for the management of their investment assets. The contracts are evidenced by written agreements which are governed by federal and state securities laws and fiduciary standards. These contracts appoint the investment advisory firm as the client's authorized agent to manage the assets placed under the direction of the advisory firm and provide for the payment of advisory fees usually based on a percentage of assets under management. These advisory contracts represent a steady flow of income to the advisory firms. Upon the sale or purchase of such a business, purchasers have traditionally paid substantial amounts for these contracts. Under long-standing federal income tax principles, purchasers have recovered the cost allocated to these contracts over their estimated useful lives through depreciation deductions.

If the Solicitor General's broad interpretation of the Third Circuit decision in *Newark Morning Ledger Co.*[1] is accepted, this long-standing tax treatment could be placed in doubt.

SUMMARY OF ARGUMENT

Congress and the Administration are currently actively cooperating in the development of legislation which would provide that virtually all purchased intangibles, including goodwill, would be depreciated over fourteen years on a straight-line basis. This Court should reject the broad rule advanced by the Solicitor General and leave the fashioning of comprehensive depreciation rules to congressional action.

The Solicitor General's definition of goodwill as including all assets any part of whose value derives from continuing customer patronage contradicts settled case law. It could encompass many intangible assets, such as investment advisory contracts,

[1] *Newark Morning Ledger Co.* v. *United States*, 945 F.2d 555 (3d Cir. 1991).

which derive value from continued customer patronage but which, when the taxpayer has adequately shown a determinable life and value, have been held by the courts to be depreciable.

The definitional approach proposed by the Solicitor General produces illogical results and would substitute a standardless inquiry for the experience-based fact findings historically made by the courts for almost eighty years. It turns on such formalisms as contract term and portion of assets purchased, rather than business realities such as the time period over which an asset is known to waste.

The Third Circuit concluded that the district court had made an error of law and entered judgment for the government. It should have remanded the case for further proceedings under its view of the correct law.

ARGUMENT

I. The Solicitor General's Broad Interpretation Of *Newark Morning Ledger* Is An Invitation To Engage In Judicial Rulemaking That Would Preempt An Ongoing Legislative Process

The Solicitor General has invited this Court to adopt the new rule of decision that purchased intangible assets which derive value from ongoing customer patronage are, as a matter of law, nondepreciable goodwill, without regard to such assets' reasonably ascertainable life, value, or other characteristics. This definitional approach to the issue is a radical substitution of a *per se* rule for the traditional case-by-case factual inquiry mandated by the statute since 1913. Since its inception in 1913, the Internal Revenue Code has permitted as a deduction "a reasonable allowance for the exhaustion, wear and tear of property."[2] This inherently factual rule — extending to both tangible and intangible assets — requires an examination of the useful life

[2] Revenue Act of 1913, 38 Stat. 114, 172.

and value of the asset at issue.[3] The Solicitor General's definitional approach also conflicts with numerous decisions of the Tax Court and other lower courts allowing depreciation with respect to a wide array of intangible assets which derive value from ongoing customer patronage.

Such a sweeping change is appropriately left for congressional action. On several occasions, Congress has adopted statutory enactments governing the depreciation of tangible and some intangible assets in an effort to ease the burden of the case-by-case rule.[4] With respect to intangible assets generally, Congress and the Administration have recently been actively cooperating in the development of legislation which would provide that virtually all purchased intangibles, including goodwill, would be depreciated over fourteen years on a straight-line basis. This legislation would eliminate the need to determine whether a particular intangible asset is separate from goodwill and whether it has a determinable life.

The legislation was passed by Congress on March 20, 1992, but vetoed by the President the same day because he objected to other provisions of the conference bill.[5] Despite the Presi-

[3] Indeed, regulations first issued by the Treasury in 1919 provided:

> If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which could be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner.

Art. 163, Regs. 45 (1919 Prelim. ed.) H.R. Doc. No. 1828, 65th Cong., 3d Sess. (1919).

The pertinent regulation in force today is similarly worded. *See* Treas. Reg. §1.167(a)-3. In the 1919 regulation, goodwill was listed as an example of a nondepreciable intangible asset and patents and copyrights were listed as examples of depreciable intangible assets.

[4] *See e.g.*, Section 168 (tangible assets), Section 195 (start-up expenditures), and Section 1253 (certain acquired franchises).

[5] *See Tax Fairness and Economic Growth Acceleration Act of 1992* — Veto message from the President of the United States, 138 Cong. Rec. H1604 (Mar. 24, 1992). As passed by Congress, the bill contained a retroactivity provision permitting taxpayers to elect to amortize intangible property over seventeen years in taxable years that were open on July 25, 1991, unless a year subsequent to the open year was closed on that date. The legislation would apparently not apply to the Petitioner in this case.

dent's veto of H.R. 4210, Treasury Assistant Secretary Goldberg testified on April 28, 1992, that the Administration continues its strong support for fourteen-year depreciation for intangibles.[6] Unlike the definitional approach advocated by the Solicitor General, which will entangle the courts in an essentially standardless, "know-it-when-we-see-it" search for goodwill, the legislation offers the prospect of ending the controversy by eliminating the need to engage in the admittedly difficult factual analysis required in intangible asset cases. This Court should reject the broad rule advanced by the Solicitor General and leave the fashioning of comprehensive depreciation rules to congressional action.[7]

II. The Solicitor General's Definition Of Goodwill As Including The Value Of All Income From Continuing Patronage Conflicts With Settled Case Law

Perhaps the greatest irony of the decision in *Newark Morning Ledger* is the Third Circuit's assertion that it was reversing the district court based on a reluctance "to take it upon ourselves to announce a sudden redefinition of a concept so fundamental to tax accounting."[8]

Sudden redefinition is precisely what the Third Circuit decision would accomplish if allowed to stand uncorrected and unlimited. The Third Circuit held that:

[6] Copies of Secretary Goldberg's testimony have been lodged with the Court and served on the Petitioner and the Respondent.

[7] As in all recent tax legislation, revenue constraints must be observed. Abandonment of a case-by-case approach in favor of the definitional approach sought by the Solicitor General could destabilize the revenue assumptions on which the legislation is based and could threaten the legislation's viability. For these reasons, this Court might, in the exercise of its sound discretion, choose to defer decision in this case until the conclusion of the legislative effort in either the current or the 1993 session of the Congress.

[8] 945 F.2d at 568.

there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable.[9]

Although the Third Circuit purported to follow the Fifth Circuit's 1973 decision in *Houston Chronicle Publishing Co.* v. *United States*, its pronouncement cannot be reconciled with that case. In *Houston Chronicle*, the court made clear that the case law

> does not establish a *per se* rule of nonamortizability in every case involving both goodwill and other intangible assets.
>
> • • •
>
> The "mass asset" rule does not prevent taking an amortization deduction if the taxpayer properly carries his dual burden of proving that the intangible asset involved (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy.[10]

The *Houston Chronicle* holding that depreciation is available if the taxpayer can make the necessary factual showing had

[9] *Ibid.*

[10] *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240, 1249-50 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974). The Fifth Circuit stated quite specifically that there was no *per se* rule of non-amortizability in cases "involving both goodwill and other intangible assets." In fact, 17% of the purchase price in *Houston Chronicle* was allocated to purchased goodwill. 481 F.2d at 1244. Thus, the attempts by the Third Circuit and the Solicitor General (945 F.2d at 562, Solicitor General's brief on petition for certiorari at n.8) to distinguish *Houston Chronicle* on the ground that it involved no goodwill because the newspaper purchased ceased publication do not accord with the Fifth Circuit's view of its own decision or with subsequent decisions by that circuit and its successors. *Laird* v. *United States*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978); *Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463 (1988), *aff'd per curiam*, 919 F.2d 1492 (11th Cir. 1990).

been, prior to the Third Circuit's decision in this case, universally accepted by the courts.

The Third Circuit is simply wrong in announcing that "the Service has consistently advanced" the definitional approach sought by the Solicitor General in this Court.[11] For example, just one year after *Houston Chronicle*, the Service reconsidered two Revenue Rulings which had asserted that acquired insurance policies and insurance expirations were indistinguishable from goodwill as a matter of law.[12] In Rev. Rul. 74-456, 1974-2 C.B. 65, the Service stated that the 1965 rulings were modified

> to remove any implication that customer and subscription lists, location contracts, insurance expirations, etc., are, as a matter of law, indistinguishable from goodwill possessing no determinable useful life. The depreciability of assets of this nature is a factual question, the determination of which rests on whether the taxpayer establishes that the assets (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy.

The Solicitor General's position in this case is clearly a rejection of the long-standing principles enunciated in *Houston Chronicle* and accepted by the Service in Rev. Rul. 74-456.[13]

[11] 945 F.2d at 568.

[12] Rev. Rul. 65-175, 1965-2 C.B. 41; Rev. Rul. 65-180, 1965-2 C.B. 279.

[13] Although the Third Circuit cited Rev. Rul. 74-456, the opinion gave no indication that the court understood that Rev. Rul. 74-456 was issued for the express purpose of rejecting the *per se* rule that the Third Circuit has now adopted. The Solicitor General's Brief on the Petition for Certiorari ignores Rev. Rul. 74-456.

III. The Solicitor General's Interpretation Of *Newark Morning Ledger* Is Overbroad And Could Encompass Intangible Assets Such As Investment Advisory Contracts Which Are Clearly Amortizable

The Solicitor General's interpretation of *Newark Morning Ledger* identifies a single factual characteristic — whether an asset derives value from continuing patronage — and concludes that any asset with that characteristic is, by "definition," goodwill. Also, under the Solicitor General's interpretation, all terminable-at-will contracts are considered to derive value from continued customer patronage and therefore are conclusively presumed to be non-amortizable goodwill.

Many business assets (tangible and intangible) derive a substantial portion of their value from continued customer patronage. As a result, the Solicitor General's approach has the necessary effect of sweeping a broad range of assets into the category of nonamortizable goodwill, including those which are recognized as depreciable by regulation and other Internal Revenue Service pronouncements. Indeed, the very examples of amortizable intangibles given by Treasury Regulations §1.167 (a)-3 — copyrights and patents — clearly derive value from customer patronage and, under the logic of the Solicitor General's rule, would become nondepreciable.

The Solicitor General's definitional approach could also potentially reach investment advisory contracts, a result that concerns amicus curiae ICAA. Since advisory contracts, as a result of almost universal practice, provide for termination by either party on relatively short notice (e.g., 30 or 60 days), they conceivably could be classified as nonamortizable simply because of this *single* characteristic.

The determination of whether an investment advisory contract is depreciable requires a review of its many factual characteristics. Each contract is evidenced by a written agreement and can be separately identified. Contracts differ from one another and impose different obligations on the investment advisory

firm depending on the various circumstances of the individual clients. The contracts typically involve the management of substantial sums and are not terminated without substantial administrative cost and effort. Investment advisory firms are subject to a broad range of oversight designed to monitor the relationship between the client and firm and to preserve full and fair disclosure, trust, and confidence.[14] The investment advisory contract represents a stable relationship which experience and extensive statistical analysis indicate will typically last for a predictable period of time. Because of the stability of these contractual relationships, substantial value is usually assigned to the contracts in the acquisition of an investment advisory firm, and the buyer proceeds on the long-standing assumption that the cost of acquiring these contracts can be recovered through amortization deductions over their estimated useful lives.

These contracts resemble in every respect a long-term contract of the sort traditionally regarded as separable from goodwill. Nevertheless, the Solicitor General's analysis is susceptible to an interpretation under which the mere fact that the contracts are terminable on short notice can cause them to be automatically treated as goodwill. Whatever the Court's conclusion with respect to the particular facts presented in the Petitioner's case, it should preserve the ability of the lower courts to resolve cases involving investment advisory contracts and other similar assets on the basis of a full factual record.

Investment advisory contracts are only one of many assets in addition to newspaper subscribers that the Solicitor General's approach could reach. For example, mortgage servicing contracts, the principal asset of a substantial sector of the business community, could be affected. These contracts are written

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[14] These include the Employee Retirement Income Security Act (29 U.S.C. §1001 *et seq.*), the Investment Advisers Act of 1940 (15 U.S.C. §80b-1 *et seq.*), the Securities Act of 1933 (15 U.S.C. §77a *et seq.*), the Securities Exchange Act of 1934 (15 U.S.C. §78a *et seq.*), the Investment Company Act of 1940 (15 U.S.C. §80a-1 *et seq.*), the Commodity Exchange Act (7 U.S.C. §1 *et seq.*), the Rules of the Municipal Securities Rulemaking Board (15 U.S.C. §78o-4; 17 C.F.R. §240.0 *et seq.*), and state securities regulations.

agreements in which one party agrees to service mortgage loans generated by the mortgagee. The agreements are usually terminable on relatively short notice. Although the contracts derive value from continuing patronage, courts have consistently ruled that they are separate from goodwill and amortizable. *Western Mortgage Corp.* v. *United States*, 308 F.Supp. 333 (C.D. Cal. 1969); *First Pa. Banking & Trust Co.* v. *Commissioner*, 56 T.C. 677 (1971), *acq.*, 1972-2 C.B. 2; *Securities-Intermountain, Inc.* v. *United States*, 460 F.2d 261 (9th Cir. 1972); *First Nat'l Bank of Omaha* v. *Commissioner*, 34 T.C.M. (CCH) 360 (1975).

Other examples within the reach of the Solicitor General's approach include a variety of intangible assets acquired as part of a going concern which derive value from continued customer patronage: television network affiliation contracts,[15] cable television franchises,[16] animal hospital patient records,[17] loan contracts,[18] credit information files,[19] covenants not to compete[20] insurance expirations,[21] fuel oil customer lists,[22] core deposits of banks,[23] athlete and entertainer contracts,[24] highway advertising service contracts,[25] linen and towel supply business customer lists,[26] wholesale grocer's franchise contracts with retail grocers,[27] patents,[28] Muzak location contracts,[29] and bus franchises.[30] Courts have held all of these assets to be depreciable where the taxpayer has adequately shown a determinable life and value.

[15] *Meredith Broadcasting Co.* v. *United States*, 405 F.2d 1214 (Ct. Cl. 1969).

[16] *Chronicle Publishing Co.* v. *Commissioner*, 67 T.C. 964 (1977), appeal dismissed, (9th Cir. Dec. 22, 1977).

[17] *Los Angeles Central Animal Hospital, Inc.* v. *Commissioner*, 68 T.C. 269 (1977).

[18] *Commissioner* v. *Seaboard Finance Co.*, T.C. Memo 1964-253, *aff'd*, 367 F.2d 646 (9th Cir. 1966).

[19] *Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223 (1975), *acq.*, 1976-2 C.B. 1.

[20] *Warsaw Photographic Associates, Inc.* v. *Commissioner*, 84 T.C. 21 (1985); Rev. Rul. 68-636, 1968-2 C.B. 92.

[21] *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446 (Ct. Cl. 1976).

[22] *Holden Fuel Oil Co.* v. *Commissioner*, 31 T.C.M. (CCH) 184 (1972), *aff'd*, 479 F.2d 613 (6th Cir. 1973).

[23] *Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990).

[24] *Laird* v. *United States*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978); *KFOX, Inc.* v. *United States*, 510 F.2d 1365 (Ct. Cl. 1975).

[25] *North American Service Co.* v. *Commissioner*, 33 T.C. 677 (1960).

IV. The Definitional Approach Urged By The Solicitor General Produces Illogical Results

The rule urged by the Solicitor General is based on the fallacious assumption that there is a clearly bounded class of assets which constitutes goodwill and another clearly bounded class of assets that is not goodwill under the same definition. The record before the Third Circuit and before this Court is confined to a single asset, namely the subscription lists of a specific group of newspapers, and thus does not provide an adequate basis for testing that hypothesis. In fact, however, the real world of intangible assets presents no such clear boundary lines.[31]

[26] *National Service Industries, Inc.* v. *United States*, 379 F.Supp. 831 (N.D. Ga. 1973).

[27] *Super Food Services, Inc.* v. *United States*, 416 F.2d 1236 (7th Cir. 1969).

[28] *Hyatt Roller Bearing Co.* v. *United States*, 43 F.2d 1008 (Ct. Cl. 1930).

[29] *Business Service Industries, Inc.* v. *Commissioner*, 51 T.C.M. (CCH) 539 (1986).

[30] *Pasadena City Lines, Inc.* v. *Commissioner*, 23 T.C. 34 (1954), *acq.*, 1955-1 C.B. 6.

[31] Indeed, the most significant distinction between goodwill and intangible assets found to be depreciable is that goodwill has an indeterminate life. Courts which have discussed the question of *why* goodwill should be non-depreciable have cited indefinite life as the rationale. *See, e.g., Dodge Brothers* v. *United States*, 118 F.2d 95, 100 (4th Cir. 1941); *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 450-54 (Ct. Cl. 1976); *Illinois Cereal Mills, Inc.* v. *Commissioner*, 46 T.C.M. (CCH) 1001 (1983), *aff'd*, 789 F.2d 1234 (7th Cir.), *cert. denied*, 479 U.S. 995 (1986); *Rost* v. *United States*, 371 F.Supp. 670, 671 (S.D. Tex. 1973). The Service itself spoke of "goodwill possessing no determinable useful life" in Rev. Rul. 74-456, *supra*. Only the

In his brief on the petition for a writ of certiorari, the Solicitor General rejects the taxpayer's argument that its subscription lists cannot be goodwill since they have a determinable useful life. The same thing, he says, "is true, and could be estimated by statistical experts, for the customers of any establishment,"[32] citing as his example a grocery store. But suppose, for example, that a grocery store has purchased contracts to supply several local businesses with their institutional grocery needs at a fixed mark-up over all costs and overhead and has records of purchases under each contract. If the contracts were for a term certain, say ten years, even the Third Circuit would apparently be prepared to recognize them as depreciable intangible assets. Certainly a purchaser would have little difficulty in demonstrating the separateness of such contracts. As this variation in facts demonstrates, the problem is one of proof, not of a bright line legal rule.

The Internal Revenue Code's depreciation provision, Section 167, requires factual inquiry, not into the manipulable legal formalism of contract term, but rather into the taxpayer's actual experience with the asset.[33] But under the Solicitor General's approach, depreciability would turn on whether the contracts were for a term certain or at will — not on the taxpayer's actual experience with the contract. This novel "rule" is even less helpful in resolving whether term contracts with early termination clauses fall on the depreciable side of the demarcation.

Third Circuit in the case before the Court has held that an asset can be non-depreciable goodwill notwithstanding a fact-finding that it has an ascertainable useful life and value.

[32] Solicitor General's Brief on Petition for Certiorari at 10-11 and footnote 7.

[33] Treas. Reg. §1.167(a)-3 requires reference to experience to determine a depreciation allowance. *See Commissioner* v. *Seaboard Finance Co.*, 367 F.2d 646, 653 (9th Cir. 1966) in which the court held that loan contracts demonstrated by experience to endure five years were depreciable over five years notwithstanding the fact that the legal term of the contracts could not exceed three years. *See also Business Serv. Indus.* v. *Commissioner*, 51 T.C.M. (CCH) 539 (1986) (contracts for stated term of five years with option to renew amortized over 15 years, the actual lives of the contracts.)

The other limitation offered by the Third Circuit — that an intangible which would otherwise be "definitional goodwill" may be depreciable if it is not purchased as part of a going concern — is equally problematic. Under this approach, if A buys subscription lists and equipment from B, but does not buy B's trade name, A may depreciate the subscription list, but if A buys the whole business, A may not depreciate the subscription lists.[34] To state the "rule" this way is to anticipate the difficulties for the lower courts in the future were this Court to adopt it. Just how much, or how little, must A not buy in order to preserve entitlement to depreciation?

It will also be difficult for courts to harmonize the definitional approach with the Treasury Department's regulations under section 1060 of the Internal Revenue Code mandating the use of the residual method in determining the value of goodwill in acquisitions of trades or businesses. The Senate Finance Committee, at the time section 1060 was enacted, stated that:

> Under the residual method, the value of the goodwill and going concern value is the excess of the purchase price of the business over the aggregate fair market values of the tangible assets and the identifiable intangible assets other than goodwill and going concern value.[35]

Example 2 of the Treasury regulations, §1.1060-1T(g), clearly contemplates that a zero allocation of purchase price to the goodwill of a going business can occur under the residual method when the values of tangible and other intangible assets

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[34] Indeed, this limitation appears to have confused the Third Circuit itself since it attempted to distinguish the *Houston Chronicle* case on the ground that the newspaper there purchased did not continue. But the *Houston Chronicle* did acquire goodwill and 17% of the purchase price was allocated to it; the *Houston Press* subscribers became *Houston Chronicle* subscribers. 481 F.2d at 1244. Would it have made a difference in the case before the Court if the Petitioner had declared the acquired newspapers terminated and begun publication on the day after the acquisition under a new name?

[35] S. Rep. No. 313, 99th Cong., 2d Sess. 252 (1986).

are sufficiently high. In contrast, under the Solicitor General's definition, which designates as goodwill all intangible assets dependent upon income from recurring customer patronage, there should always be positive value for the goodwill of a business with recurring customers. If the Solicitor General's definitional approach to goodwill is adopted, the courts will have to sort out these contradictory allocation principles.

But the fundamental difficulty of the definitional approach is inherent in its basic concept. If the value of an intangible asset must be "*completely* independent" of repetitive customer patronage to escape classification as goodwill, then the rule is impossibly broad. Patents and copyrights, software and package designs, despite their recognition by the Internal Revenue Service as separate, depreciable intangible assets,[36] would logically be a part of goodwill under such an approach. The income streams on which the value of these intangible assets depends is itself typically dependent on recurrent customer purchases.[37] If the formulation were "*primarily* independent" of recurring customer patronage, the standard becomes even less clear and more subjective.

Adoption of the definitional approach would move courts from a difficult, but nonetheless familiar, manageable and

[36] *See* Rev. Proc. 69-21, 1969-2 C.B. 303 (computer software) and Rev. Proc. 90-63, 1990-2 C.B. 664 (package design costs). These assets are particularly likely to depend on recurrent customer patronage for their value. *See also* Rev. Rul. 67-379, 1967-2 C.B. 127 (player contracts) and Rev. Rul. 68-636, 1968-2 C.B. 92 (covenants not to compete).

[37] As the Third Circuit recognized, such a definition effectively precludes use of the income valuation method since the income stream of any business asset is always dependent to some degree on customer patronage. Restricting intangible asset valuation to the replacement cost method (the only basis recognized by the Third Circuit) is at odds with economic reality and good valuation practice. No willing seller of a successful patent would consider parting with valuable patent rights merely for cost reimbursement. The sale price will instead be based on the parties' evaluation of the future income stream attributable to the patent. Treating the patent's income stream as goodwill (rather than as the value of the patent itself) simply because its value derives from the recurring patronage of purchases of the patented product is to ignore the marketplace. This valuation problem does not differ for many other intangible assets.

comprehensible, inquiry — can a separate intangible asset be identified[38] and its life and value ascertained — to a largely standardless inquiry into whether the asset is the "essence" of goodwill. This novel approach would make irrelevant what has heretofore been the most critical inquiry in a depreciation case — whether an ascertainable life can be determined for the asset based on the taxpayer's experience.

V. Resolution Of This Case Does Not Require Articulation Of A New Legal Standard; The Case Can Be Resolved On The Narrow Grounds Of Whether The Taxpayer Satisfied Its Burden Of Proof Under The Facts-And-Circumstances Standard

The Third Circuit decision is susceptible of two interpretations — the broad, definitional approach advanced by the Solicitor General, and a much narrower approach that is truer to the long-standing facts-and-circumstances test.

As demonstrated above, the broad view advanced by the Solicitor General is problematic. It conflicts with long-standing case law; it substitutes judicial rulemaking for legislation; it potentially reaches a broad range of assets historically consid-

[38] The separateness inquiry and identification inquiry are the same. In both cases, the question is whether the particular income stream being valued is properly attributable to the asset in question. Tax Court Judge Cohen recently stated in concurring in *Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. at 515-16:

> I have found *no* authority for the proposition that assets, intangible or tangible, are not separate and distinct from goodwill unless no part of their value is related to continued patronage of customers of an ongoing business. As the majority opinion demonstrates in its exhaustive analysis of relevant authorities, assets are frequently found to be eligible for amortization even though the price paid took into account the probable continuance of terminable business relationships . . . Tangible property, such as special purpose equipment, is unquestionably subject to depreciation even though its value may be enhanced by its use in an ongoing business. It seems to me that the requirement that an asset be separate and distinct means only that it must have a measurable value for a specific use.

ered depreciable and not before the Court in this case; and it produces unworkable and illogical results. The Third Circuit itself stated that it intended to follow the case law as announced by *Houston Chronicle* and that the Petitioner lost because it did not meet its burden of proof. Much of the language which the Solicitor General relies on for his broad interpretation is unnecessary to the Third Circuit's decision and should properly be treated as *dicta*.

Under a more restricted reading, the issue to be resolved is limited to whether the Petitioner satisfied its burden of demonstrating that the value of the acquired newspaper subscribers was separate from goodwill. The district court found as facts that the acquired newspaper subscribers possessed lives that were determinable with reasonable accuracy and had an ascertainable value that was separate from goodwill. The district court then concluded that the Petitioner was entitled to depreciate the value of the acquired subscribers over their estimated useful lives. The Third Circuit reversed the district court's judgment on the basis that one of the district court's findings was clearly erroneous — the finding that the value of the acquired subscribers was separate from goodwill.

According to the Third Circuit, the Petitioner advanced inadequate evidence on which to base this distinction. To demonstrate the distinction from goodwill the Petitioner had relied on a syllogism: that, if it could be shown the acquired subscribers had a limited life (a point which the Government conceded on appeal), then it must follow that the acquired subscribers were not goodwill. The Third Circuit did not accept this reasoning. Rather than remand the case for reconsideration in light of its decision that additional proof of separateness was required, the Third Circuit concluded that the record was sufficient to enter judgment for the Government. This conclusion was error. It is not the proper role of an appellate court to decide the case under its view of the correct law as if it were the trier of fact. *Pullman-Standard* v. *Swint*, 463 U.S. 273, 290-93 (1982) ("where findings are infirm because of an erroneous view of the law, a

remand is the proper course unless the record permits only one resolution of the factual issue"); *Kelley* v. *Southern Pacific Co.*, 419 U.S. 318, 331-32 (1974).

If this Court finds that the district court applied the correct legal principle in evaluating the facts before it, it follows that the decision of the district court should be affirmed. If this Court, however, should decide that the district court applied an incorrect legal principle in considering the facts before it, the case should be remanded to the district court for further action in accordance with the appropriate legal principle.

CONCLUSION

The Solicitor General's broad interpretation of the Third Circuit's decision conflicts with the well-settled facts-and-circumstances approach to determination of the depreciability of an intangible asset. The government's failure to join issue on the critical factual matters of life and value in the district court was directly responsible for the district court's decision for the Petitioner. Given the stipulations presented to that court as to life and the evidence adduced on value, the district court's decision was not clearly erroneous and should be reinstated.

In particular, this Court should not substitute a poorly defined legal presumption for factual inquiry into life and value. A concept which is so fundamental to proper income measurement as depreciation should not turn on legal formalisms such as contract term and how much or how little of a business is acquired by a taxpayer. The Solicitor General's formalistic approach is not grounded in precedent and is at odds with economic reality. This Court should reaffirm the *Houston Chronicle* holding that depreciation of intangibles is a factual issue, dependent on the proof in each case. This Court should preserve for Congress the same freedom of action with respect to its currently pending legislation on intangible assets as that body

enjoyed in resolving similar controversies which had earlier arisen with respect to tangible assets.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER COMPANY,
as successor to The Herald Company,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF WORRELL ENTERPRISES, INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the Third Circuit, in acknowledged conflict with other circuits and the United States Tax Court, was correct that under the Internal Revenue Code an income-producing wasting intangible asset may be nondepreciable "goodwill" as a matter of law.

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BRIEF OF WORRELL ENTERPRISES, INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF AMICUS CURIAE

Worrell Enterprises, Inc. ("Worrell Enterprises") is a Delaware corporation with its principal place of business in Boca Raton, Florida. Worrell Enterprises currently owns and operates approximately 70 newspapers in 9 States across the United States, from New Jersey to Florida and from Florida to California. Worrell Enterprises and certain affiliated entities and related individuals (collectively the "Worrell group") are contesting, in one matter before the Internal Revenue Service and in a second matter in the United States District Court for the Southern District of Florida, the amortization of newspaper subscriber relationships acquired by the Worrell group when it acquired, along with the other assets, several of its newspaper publishing companies.

The decision of the Third Circuit Court of Appeals in the case with respect to which this brief is being filed, if permitted to stand, may adversely affect not only the matters being contested by the Worrell group but also the Worrell group's tax liabilities in future years. The Third Circuit's decision is fundamentally inconsistent with nearly two decades of settled legal authority. The Worrell group believes that its views, business practices and settled business expectations will be of assistance to the Court in determining that the issue of whether newspaper subscriber relationships are amortizable for tax purposes is, contrary to the conclusion of the Third Circuit, an issue of fact rather than a matter of law, or if it is determined to be a matter of law, that newspaper subscriber relationships are clearly amortizable.

Counsel for both parties have consented to our appearance as amicus curiae. Their written consents are filed together with this brief.

SUMMARY OF THE ARGUMENT

The Worrell group has, for nearly two decades, determined the purchase price of newspapers that it acquired by relying on (1) the economically demonstrable fact that newspaper subscriber relationships have both a determinable and limited useful life, the duration of which can be ascertained with reasonable accuracy, and an ascertainable value separate and distinct from goodwill that can be determined by using standard valuation techniques and generally accepted accounting methods, and (2) the law as reflected in the Internal Revenue Service's own published 1974 revenue ruling and in many cases since 1973 (for example, *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974); *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987)) that the taxpayer can, as a matter of fact and by satisfying its burden of proof, demonstrate that its subscriber relationships are amortizable for income tax purposes.

ARGUMENT

1. In reliance on Rev. Rul. 74-456, in which the Internal Revenue Service recognized that the amortizability of newspaper subscriber relationships is a question of fact rather than a matter of law, the Worrell group has evaluated more than 100 potential acquisitions and has priced and acquired more than 40 newspapers.

In 1974, the Internal Revenue Service published Rev. Rul. 74-456, 1974-2 C.B. 65, modifying two 1965 revenue rulings and interpreting section 1.167(a)-3 of the Income Tax Regulations:

> *to remove any implication* that . . . subscription lists . . . are, as a matter of law, indistinguishable from goodwill possessing no determinable useful life. The depreciability of assets of this nature is a factual question, the determination of which rests on whether the taxpayer establishes that the assets (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy. *Id.* at 66. (Emphasis added.)

During the 18 years since the publication of Rev. Rul. 74-456, *supra*, the Worrell group has evaluated more than 100 potential newspaper acquisitions and has acquired more than 40 newspapers. While there are many elements in the evaluation process when a newspaper is being purchased, the key element in pricing a newspaper, in reliance on Rev. Rul. 74-456, *supra*, and the long-standing policy of the Internal Revenue Service, is the analysis of existing subscribers.

Subscriber analysis is critical for the following reasons:

A comparison of paid subscribers to the population of the area demonstrates market penetration and, hence, the newspaper's potential share of the total market's advertising revenues. Subscriber analysis also develops an advertising rate range, the potential or correct amount a newspaper should

charge its advertisers. Advertising revenues represent more than 75% of the gross revenues of the Worrell group's newspapers, and the subscriber list is, in each case, the "machine" that generates those advertising revenues.

The Worrell group, as a newspaper acquirer, must understand and demonstrate market penetration, because the key to selling advertising is for the advertiser to see definitive results from running an advertisement. Gauging market penetration and, more importantly, readership shows potential newspaper advertisers the effect of their advertisements as compared with other advertising media, such as radio, television, and other newspapers. A keen understanding of subscribers, including their income, education, literacy, mobility and age, provides the empirical data necessary to determine, with some precision, the newspaper's potential share of the advertising dollars spent in the market.

The final element of a subscriber list analysis involves a correlation of the to-be-acquired newspaper's particular subscribers with advertising rates, based upon the Worrell group's internally-generated correlation studies. In determining advertising rates, a newspaper must compare its individual and household coverage with the other advertising media in the same market. A newspaper has the ability to charge a premium compared with other forms of advertising because paid subscriptions provide a higher degree of certainty that the advertisement will be communicated to the potential buyer. While radio, television and billboard companies can generate statistical abstracts to estimate the number of people exposed to a particular advertisement, a newspaper enjoys a distinct advantage because, through audit procedures, there is absolute certainty that a specific number of individuals who have paid the subscription price will have received a copy of the advertisement.

In summary, the primary and long-standing principle of the Worrell group is to evaluate subscriber information in the process of making newspaper acquisitions. This methodology demonstrates the competitiveness of the market, the ability of

a newspaper to sell advertising, the rate at which advertising should be sold and, accordingly, the estimated gross revenues of the newspaper.

In contrast, when analyzing newspapers that do not have paid subscribers, the Worrell group focuses on advertiser relations and specific market niches. Those attributes of a free distribution newspaper are so nebulous that the purchase price paid to acquire it is seldom more than 20% of the price paid for a newspaper that is based on a paid subscriber network.

The main element in evaluating subscribers entails the determination of the estimated life of the subscriber group. In the mid-1970's, in the process of making an acquisition, the Worrell group's chief executive officer, chief financial officer and their staffs internally estimated the value of the target newspaper's subscriber relationships and, subsequent to the acquisition, retained an independent appraisal company to formalize the valuation process. Both the internal process and the formal appraisal entailed evaluating the age of the population, the different levels of standard of living, and the market migration rate. These factors produced an annual subscriber termination rate for the particular acquired newspaper. All newspapers lose subscribers from death, migration and cancellation. The standards of living of the various segments of the population provide keen insight into cancellation rates. Where standards of living are low on the average, the literacy level is also low and people are more likely to cancel because they lack the desire to read the newspaper. By contrast, in a market having an extremely high standard of living, cancellations may result from the political perspective of the newspaper.

This evaluation process evolved in the late 1970's and early 1980's so that subsequent acquisitions up to the present time by the Worrell group have entailed the following additional procedures:

1. Prior to negotiating the purchase price of a newspaper, demographic information is obtained in order that the Wor-

rell group can determine internally the life and value of the newspaper's subscribers.

2. In the purchase documents, the value of the subscribers is usually separately stated. In all cases, the sellers represent and warrant the number of paid subscribers.

3. Many acquisition agreements include a formula under which the purchase price is to be reduced if the actual number of subscribers, determined after the closing of the acquisition, is found to be less than the number represented by the sellers.

4. Prior to or simultaneously with the culmination of the acquisition, an appraisal company is retained to formalize the prior estimate of the life of the subscribers and to place a value on the subscription relationships as a separately negotiated for, and separately purchased, asset.

5. To ascertain the validity of the life methodology used, the Worrell group performs an additional analysis several years subsequent to the acquisition. The subscribers at the time of acquisition are compared with the then current subscribers. From this analysis, an exact exhaustion rate of the subscriber base can be obtained.

II. There are established appraisal and accounting methods for determining the useful life and value of newspaper subscriber relationships, and the Worrell group, as a matter of settled business expectations, has followed these methods since the 1970's in its acquisition of newspapers.

Determining the useful life of subscribers since the 1970's has been accomplished by the Worrell group through the use of some or all of the following techniques:

a. The Worrell group would obtain information as to the several years prior to the acquisition to determine, on a monthly basis, the numbers of new and cancelled subscribers. This information, used in conjunction with the number of subscribers at the beginning and at the end of the period,

produces a factor showing the decline of the subscriber base, if efforts are not undertaken to obtain new subscribers.

b. Telephone surveys would be utilized to determine migration and cancellation rates as well as the length of time that individuals have subscribed to the newspaper. Using the gross population, cancellation rates and death rates over a period of years can also produce the rate at which the number of subscribers will decline, if solicitation is not undertaken to acquire new subscribers.

c. The Audit Bureau of Circulation, the largest national independent auditing company on which newspapers, advertisers and advertising agencies rely, would furnish verified, accurate numbers of paid subscribers in specific newspaper market areas, and its data would be used to verify the figures furnished by the seller as well as the figures developed by the Worrell group.

d. The Worrell group would analyze many of the factors that enter into the determination of useful life, to the extent relevant to the particular acquisition, including market penetration (the ratio of paid subscribers to total market population); the number of subscribers; their distribution by age, education and standard of living; other economic and geographical factors; the number and type of competing newspapers as well as other media; the illiteracy rate; and the number of people who read each copy of the newspaper.

The number of subscribers dwindles as members of the original group of subscribers cancel, move or die. There is no "mass asset" that replenishes itself. Rather, great effort and expense must be expended to produce one new subscriber. Typically, as confirmed by readily-available industry-wide data, substantial expense and at least 25 new orders must be taken by an average newspaper in order to increase its circulation by one. Not only must substantial expense be incurred, but there is also a frequent need to change the content of a newspaper in order to attract younger readers or to broaden the geographical market area so as to increase the number of paid subscribers.

III. The Worrell group has relied on the 1974 Revenue Ruling, case authority, an extended Internal Revenue Service audit of the Worrell group's amortization practices, and the refusal by Congress in 1987 to prohibit the amortization of newspaper subscriber relationships. If amortization had been prohibited, the Worrell group would have purchased the acquired newspapers at a lower price or not at all.

The Worrell group has, for nearly two decades, determined the purchase prices for its acquisitions of other newspapers by valuing newspaper subscriber relationships pursuant to standard valuation techniques and generally accepted accounting methods. In doing so, the Worrell group has relied upon the law as reflected in the Internal Revenue Service's own published 1974 revenue ruling, as well as the many cases since 1973 holding that a taxpayer can, by satisfying its burden of proof, demonstrate that its subscriber relationships are amortizable for income tax purposes.

Amortization of several subscriber relationships relating to acquisitions of other newspapers by the Worrell group was expressly reaffirmed by the Internal Revenue Service in a field audit of the tax years ended February 1979 through February 1983. The Internal Revenue Service then submitted its audit conclusions to the Joint Committee on Taxation, which reviewed and approved the audit report. Thus, Internal Revenue Service conduct reaffirmed the approach of the Worrell group in determining how much to pay for a newspaper, how much of the purchase price to allocate to its subscriber relationships, and the useful life over which to amortize the subscriber relationships. Similarly, when Congress refused in 1987 to bar the amortization of subscriber relationships and other intangibles as a matter of law, the pricing methodology of the Worrell group in acquiring newspapers and amortizing the subscriber relationships for tax purposes was reaffirmed. See Section 10120 of H.R. 3545, the Revenue Bill of 1987, which was enacted (without Section 10120) as Title X of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-1382 (1987).

CONCLUSION

Settled business expectations and established methods of valuing and acquiring newspapers over nearly two decades will be upset unless the Court decides that the amortization of newspaper subscriber relationships remains a question of fact under the Internal Revenue Code, or if amortization is held to be a matter of law, that newspaper subscriber relationships are clearly amortizable.

The decision of the Third Circuit should be reversed.

Respectfully submitted,

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On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF AMICUS CURIAE OF NEWSPAPER ASSOCIATION OF AMERICA (FORMERLY AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION) IN SUPPORT OF PETITIONER

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BRIEF AMICUS CURIAE OF NEWSPAPER ASSOCIATION OF AMERICA (FORMERLY AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION) IN SUPPORT OF PETITIONER

STATEMENT OF INTEREST

Newspaper Association of America ("NAA") is a non-profit trade association representing approximately 1,700 member newspapers.[1] Its membership includes newspapers that are responsible for about 90 percent of the total daily and Sunday newspaper circulation, and a substantial portion of the non-daily newspaper circulation, in the United States.

[1] Prior to June 1, 1992, NAA was known as American Newspaper Publishers Association. Its name changed on June 1, 1992 when several other newspaper groups merged with it to form NAA.

NAA submits this brief *amicus curiae* in support of Petiitoner.[2] Many NAA members, including Petitioner itself, have acquired operating newspapers in the past and will continue to acquire operating newspapers in the future. In most newspaper acquisitions, a relatively small portion—perhaps 20 percent to 30 percent—of the purchase price can be traced to the tangible assets. For example, the acquisitions of Petitioner that are the subject of this lawsuit involve tangible assets with a value of only approximately 23 percent of the purchase price of the newspapers. See summary of values, Pet. App. at 36a.

Believing that few, if any, assets used in a business have a permanent value, many NAA members that acquired newspapers analyzed what portion of the amount that they paid in excess of the value of the tangible assets could be expected to decline over time. They knew in particular that the paying subscribers that existed on the date of purchase (the "initial paid subscribers") would be of use in the business for only a limited period of time. They also knew that the initial paid subscribers were valuable assets primarily because they served to attract advertisers. Accordingly, NAA members concluded that the portion of the purchase price attributable to the initial paid subscribers was properly depreciated over the useful lives of those subscribers.

Economic consulting and valuation experts engaged by NAA members generally confirmed the business conclusions described above. The experts advised NAA members that the useful lives of the initial paid subscribers could be determined with reasonable accuracy and that a value could be assigned to those subscribers. Accordingly, many NAA members claimed depreciation deductions on their federal income tax returns.

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[2] Written consents of both parties have been filed with the Clerk of the Court as required by Rule 37 of this Court's rules.

Many NAA members now find themselves in the same position as Petitioner in this case: they have depreciated the basis of the initial paid subscribers, and the Internal Revenue Service has disallowed the claimed deductions. Those members therefore have a strong interest in the outcome of this case.

SUMMARY OF ARGUMENT

By virtue of (i) the district court's unchallenged finding that the initial paid subscribers had limited useful lives which could be estimated with reasonable accuracy, and (ii) the clear mandate of long-standing depreciation rules that wasting assets with limited useful lives are depreciable, the initial paid subscribers should be found to be depreciable. In deciding that the initial paid subscribers were not depreciable, the Court of Appeals for the Third Circuit virtually ignored these points and instead relied upon various judicial definitions of "goodwill". It did not attempt to interpret the applicable Treasury regulation according to the regulation's own words and in the context of the facts of this particular case. It thus approached the issue as an empty semantic exercise, rather than one of regulatory interpretation.

The result reached by the Third Circuit is unsound for three distinct reasons:

First, the Internal Revenue Code and its implementing regulations require that wasting intangible assets be depreciated in order to clearly reflect income. Depreciation deductions for the initial paid subscribers are no different than depreciation deductions for purchased tangible assets.

Second, the Third Circuit's approach results in similar intangible assets—a patent and the initial paid subscribers—being treated differently, even though their tax characteristics are otherwise identical.

Finally, in undertaking its analysis, the Third Circuit viewed newspaper subscribers merely as customers. However, newspaper subscribers are not only customers, they are an asset used by a newspaper to reach its more important customers, which are its advertisers. Accordingly, to identify newspaper subscribers with customers, and customers with "goodwill", misses the fundamental nature of newspaper subscribers.

ARGUMENT

I. THE COST OF WASTING INTANGIBLE ASSETS, LIKE THE COST OF WASTING TANGIBLE ASSETS, MUST BE RECOVERED OVER THE USEFUL LIVES OF THE ASSETS.

A. Introduction.

There is no dispute in this case that Petitioner's initial paid subscribers have limited useful lives that can be estimated with reasonable accuracy. Petitioner and the government entered into a stipulation setting forth the useful lives of the initial paid subscribers for each newspaper involved. Pet. App. at 32a. The district court unequivocably stated that Petitioner "has clearly established that the paying subscribers . . . of the acquired newspapers had limited useful lives, the duration of which can be and has been estimated with reasonable accuracy." *Id.* The Third Circuit admitted that the government never challenged the expert testimony regarding useful lives and that the government had entered into the stipulation establishing the useful lives. Pet. App. at 6a.

Given these uncontroverted facts and the clear mandate of the depreciation rules that wasting assets with limited useful lives are depreciable, it should follow that the initial paid subscribers are, in fact, depreciable. Yet the Third Circuit held to the contrary.

In deciding this case, the Third Circuit stated that it was applying Treas. Reg. § 1.167(a)-3, which provides in part

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to good will.

Despite the first sentence quoted above from the regulation and the uncontroverted fact that the initial paid subscribers had useful lives which could be estimated with reasonable accuracy, the Third Circuit held that

> for tax purposes, there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable. [Pet. App. at 28a-29a.]

Although the Third Circuit purports to ground its holding in the case law, in fact no prior court had ever made this bald assertion. It conflicts with the long-standing mandate and purpose of the statute authorizing depreciation deductions for wasting assets with limited useful lives. It also conflicts with the government's own implementing regulations.

B. The Statutory and Regulatory Scheme.

The curent statutory provision that allows the recovery over time of the cost of wasting assets is found in section 167(a) of the Internal Revenue Code of 1986 (the "Code").[3] It provides as follows:

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[3] All statutory references in this brief are to the Code unless otherwise specified.

> (a) GENERAL RULE.—There shall be allowed as a depreceiation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

In discussing the purpose of this provision when it was enacted as part of the Internal Revenue Code of 1954, Congress stated that:

> Depreciation allowances are the method by which the capital invested in an asset is recovered tax-free over the years it is used in a business. The annual deduction is computed by spreading the cost of the property over its estimated useful life.

H.R. Rep. No. 1337, 83d Cong., 2d Sess. 22 (1954).

The purpose of the statute is to accurately match income with the expenses of generating that income. For example, in *Massey Motors v. United States*, 364 U.S. 92 (1960), this Court stated the following:

> It was the purpose of § 23(1) [the predecessor of section 167(a)] and the regulations to make a meaningful allocation of this cost [of a capital asset] to the tax periods benefited by the use of the asset.

Id. at 96. This Court also stated that

> [i]t is the primary purpose of depreciation accounting to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use (excluding maintenance expenses) of the asset to the periods to which it contributes.

Id. at 104; *see also INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039, 1043 (1992) ("through provisions such as [section 167(a)], the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of the net income for tax purposes."); *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 10-11 (1974) (collecting cases).

The statute unambiguously mandates that a depreciation deduction "shall" be allowed for wasting assets. In *Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128 (8th Cir. 1960), the Eighth Circuit interpreted a Treasury regulation promulgated under the predecessor to section 167(a) (which is substantially identical to current section 167(a) of the Code). The Eighth Circuit recognized the mandatory aspect of the statute:

> It is our belief that the statute authorizing the deduction is mandatory and not permissive, and requires the Commissioner to grant the deduction to a taxpayer who brings his claim within the provision of the statute.

277 F.2d at 131-32. Additionally, the statutory language does not distinguish between tangible and intangible assets. *See Northern Natural Gas*, 277 F.2d at 139 (Blackmum J. concurring) (predecessor to section 167(a) "does not distinguish between tangible and intangible assets and it says nothing by way of disqualifying an asset for depreciation merely because it is an intangible.").

The statutory mandate in section 167(a) is implemented by Treasury Regulations. Treas. Reg. § 1.167(a)-1(a) provides in part that

> [t]he allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property. . . .

This allows the cost of an asset (less its estimated salvage value) to be recovered over the asset's estimated useful life. Treas. Reg. § 1.167(a)-1(b) defines in some detail the "estimated useful life". It provides in pertinent part that

> [f]or the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the

> asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income.

The basic rule of these regulations is therefore to allow the taxpayer to recover the cost of an asset (less its salvage value) over its useful life.

Treas. Reg. § 1.167(a)-3 mirrors that basic rule in the context of intangible assets by providing that:

> [i]f an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance.

This provision embodies the same basic rule as the regulations allowing the recovery of the cost of wasting tangible assets: the cost of a wasting asset is to be recovered over its useful life.[4]

In summary, both section 167(a) and its implementing regulations provide that the cost of a wasting asset, tangible or intangible, may be depreciated. Furthermore, the purpose of section 167(a) and the regulations issued thereunder is to accurately match income and the expenses of generating the income. The law was summarized by the Eighth Circuit in *Northern Natural Gas*:

> The right-of-way here involved constitutes property. The parties concede that the right-of-way is intangible property and we shall so assume. We observe here, however, that the statute itself makes no distinction between tangible and intangible property.

[4] Treas. Reg. § 1.167(a)-3 simply adds the requirement that the useful life of an intangible asset be estimated "with reasonable accuracy". The district court found that Petitioner had established that the initial paid subscribers had useful lives that had been determined with reasonable accuracy. Pet. App. at 32a. The Third Circuit did not set that finding aside. Thus, the slight difference between the general standard of Treas. Reg. § 1.167(a)-1(b) and the specific standard of Treas. Reg. § 167(a)-3 is immaterial for purposes of this case.

> *If the taxpayer's income producing property is undergoing exhaustion, the statute authorizes a depreciation deduction.*

277 F.2d at 131 (emphasis added).

C. Interpretation of Treas. Reg. § 1.167(a)-3 in Light of Statutory and Regulatory Scheme.

This case centers around the interpretation of Treas. Reg. § 1.167(a)-3. Because initial paid subscribers are intangible assets with limited useful lives which can be estimated with reasonable accuracy, the initial paid subscribers should be depreciable by virtue of the first sentence in Treas. Reg. § 1.167(a)-3. However, Treas. Reg. § 1.167(a)-3 also states that "goodwill" is nondepreciable. The regulation does not define 'goodwill" and the term has no commonly-accepted definition.[5] (This brief will consistently refer to "goodwill" in quotation marks, to emphasize that the term has no commonly-accepted definition.) Therefore, the application of Treas. Reg. § 1.167(a)-3 must be determined by applying established rules of regulatory construction.

Those established rules require that Treas. Reg. § 1.167(a)-3 be interpreted so as to be consistent with, and not to conflict with, the purposes of section 167(a), the statute it implements. *See, e.g., Dixon v. United States*, 381 U.S. 68, 74 (1965) (regulations may not be interpreted in such a manner as to go beyond the author-

[5] For example, "goodwill" has been defined as

- an intangible asset "that has no ascertainable useful life,"
- "the aggregate of all of the intangibles of a business,"
- "the return on all the intangibles of a business,"
- "a rate of return on investment which is above normal returns in the industry," and
- "the expectancy that the old customers will resort to the old place."

See Richard S. Miller & Sons, Inc. v. United States, 537 F.2d 446, 450-51 (Ct. Cl. 1976).

ity of the statute they implement); *Bank of New York v. United States*, 526 F.2d 1012, 1018 (3d Cir. 1975) ("Treasury Regulations must be interpreted in the context of the statute they are designed to explicate; 'there is no power to amend [a statute] by regulation.'") (quoting *Koshland v. Helvering*, 298 U.S. 441, 447 (1936)); *Trustees of Indiana University v. United States*, 618 F.2d 736, 739 (Ct. Cl. 1980) ("a regulation must be interpreted so as to harmonize with and further and not to conflict with the objective of the statute it implements").

Additionally, Treas. Reg. § 1.167(a)-3 should be interpretated so as to be consistent with the other provisions of the Treasury's own regulatory scheme under section 167(a). *See Northern Natural Gas*, 277 F.2d at 135 (the court "fully agrees with the view expressed by Judge Blackmun that [the predecessor of Treas. Reg. § 1.167(a)-3] cannot be viewed and interpreted in isolation. The regulation is part of a group of comprehensive regulations dealing with the depreciation deduction and all such regulations should properly be construed together as a whole"); *see also McCoog v. Hegstrom*, 690 F.2d 1280, 1284 (9th Cir. 1982) (deference due an administrative interpretation depends in part on "the purpose and wording of other agency regulations").

The first sentence of Treas. Reg. § 1.167(a)-3 provides the basic rule that an intangible asset, the useful life of which can be estimated with reasonable accuracy, may be depreciated. The regulation gives patents and copyrights as examples. Next, the regulation provides the corollary rule that an intangible asset, the useful life of which is not limited, is not depreciable. The regulation then states that no depreciation deduction is allowable for "goodwill". The regulation says nothing more on the subject.

In view of the basic rule of the statute and the scheme of the section 167(a) regulations, the initial paid subscribers should be treated as falling within the first sentence of Treas. Reg. § 1.167(a)-3 because they are intangible assets with limited useful lives which can be estimated with reasonable accuracy. Correspondingly, the reference to "goodwill" in Treas. Reg. § 1.167(a)-3 should be treated as an *example* of the corollary rule in the regulation that an intangible asset without a reasonably determinable useful life cannot be depreciated. Under this approach, Treas. Reg. § 1.167(a)-3 should be interpreted as providing that "goodwill" is nondepreciable *because* it does not have a reasonably ascertainable useful life. *See, e.g., Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 451 (Ct. Cl. 1976) ("Since by definition goodwill has no ascertainable useful life, the presumption that this intangible is a nondepreciable capital asset is conclusive."); *Colorado National Bankshares, Inc. v. Commissioner*, 60 T.C.M. 771, 789 (1990) ("Goodwill, by definition, has an indefinite life . . . ."); H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 936-37 (1987) ("because goodwill does not have a determinable useful life, no depreciation deduction is allowed with respect to that intangible asset.").

Read in this way, the sentence in Treas. Reg. § 1.167(a)-3 concerning "goodwill" would not apply to any asset with a reasonably ascertainable useful life, and therefore such an asset would be depreciable. This is consistent with both the statutory mandate of a depreciation allowance for wasting assets and the general scheme of the section 167(a) regulations that allows depreciation for all assets with limited useful lives. It is also consistent with the purpose of section 167(a), which is to match income with the expenses incurred to produce the income.

D. The Errors of the Third Circuit's Approach.

The Third Circuit chose to virtually ignore the first sentence of Treas. Reg. § 1.167(a)-3 and to look outside of the four corners of the regulation to interpret the

term "goodwill". It engaged in the purely semantic exercise of determining how "goodwill" has been used by various courts. It did so even while admitting that "goodwill" is an "elusive concept" and that there is no "uniform or coherent definition of the term." Pet. App. at 10a n.5. Without adopting any rigorous definition of "goodwill", it determined that the initial paid subscribers were inextricably entwined with "goodwill" and therefore were not depreciable. Yet it left undisturbed the district court's factual finding that they have limited useful lives that can be determined with reasonable accuracy, *i.e.*, that they are wasting assets.

In effect, the Third Circuit read the provision in Treas. Reg. § 1.167(a)-3 concerning "goodwill" as an *exception* to the basic rule that wasting assets are depreciable, instead of as an *example* of the corollary rule that assets without a reasonably ascertainable life are not depreciable. This interpretation of the regulation's reference to "goodwill" violates the rules for regulatory construction set forth above. It conflicts with the mandate of the statute and the regulatory scheme under section 167(a) that wasting assets, whether tangible or intangible, be depreciated. *Northern Natural Gas*, 277 F.2d at 131-132. Moreover, the Third Circuit's approach conflicts with the purpose of the depreciation allowance, which is to match income with the expenses incurred to generate the income. *Massey Motors*, 364 U.S. at 104.

Furthermore, the Third Circuit's interpretation of "goodwill", as that term appears in Treas. Reg. § 1.167(a)-3, treats intangible assets with reasonably ascertainable useful lives differently from tangible assets with reasonably ascertainable useful lives, and therefore is inconsistent with the statute and the section 167(a) regulations. As the Third Circuit admitted in its opinion,

> we believe that the Service is correct in asserting that, for tax purposes, there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable. [Pet. App. at 28a-29a.]

This would be an extraordinary statement if applied to tangible assets. It is equally extraordinary when applied to intangible assets, because the statute does not distinguish between tangible and intangible assets and the regulations applying to intangible assets are essentially the same as those applying to tangible assets.

The inconsistency created by the Third Circuit's opinion can be seen by comparing two situations, one involving tangible assets and one involving intangible assets. Suppose the following facts: Taxpayer A purchases a delivery service that has one hundred delivery trucks at the time of purchase. The delivery trucks have an average useful life of eight years. (In this particular case, the useful life would be determined under section 168, rather than by a facts and circumstances analysis. This is not relevant for purposes of this analogy.) Ten years later, Taxpayer A is still operating the delivery service and still has one hundred delivery trucks. Assume that by that time, all of the trucks acquired as part of the original purchase have been retired and replaced. The tax law allows Taxpayer A to recover the cost of the initial one hundred trucks over their eight-year useful life, even though Taxpayer A still has one hundred trucks at the end of ten years.

Now suppose Taxpayer B purchases a newspaper that has one hundred subscribers at the time of purchase. The initial subscribers can be expected to remain subscribers for an average of eight years. Ten years later, Taxpayer B is still operating the newspaper and still has one hundred subscribers. Assume that by that time, all of the subscribers acquired as part of the original purchase have left the newspaper and have been replaced.

Under the Third Circuit's approach, the portion of the purchase price paid by Taxpayer B that is allocable to the initial one hundred subscribers would not be recov-

ered for tax purposes over their eight-year useful life. Taxpayer B, which is in exactly the same economic situation as Taxpayer A, bears a heavier tax burden than Taxpayer A under the Third Circuit's approach merely because Taxpayer B bought a business with a significant intangible asset.

It is not relevant that in the case of Taxpayer A the costs of replacement trucks will be capitalized and then depreciated, while in the case of Taxpayer B the costs of replacing subscribers will be deducted. First, Treas. Reg. § 1.167(a)-3 does not tie the depreciation deduction to the tax treatment of replacement costs, either implicitly or explicitly. It simply requires that the asset be useful in the business for only a limited period, the length of which can be estimated with reasonable accuracy.

Second, Taxpayer A will not necessarily capitalize all of the costs of replacing the trucks. Under section 179, Taxpayer A may be permitted to deduct up to $10,000 of the cost of new replacement trucks each year. Yet NAA is not aware that the Commissioner of Internal Revenue (the "Commissioner") has ever argued that a deduction for replacement costs means that the cost of the initial one hundred trucks is not depreciable. Similarly, the fact that section 173 allows a taxpayer to deduct replacement costs for subscribers [6] has no bearing on whether the cost of the initial one hundred subscribers is depreciable.

Accordingly, the Third Circuit's approach treating tangible and intangible assets differently flies in the face of the statute, the regulations, and sound economic and tax policy.

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[6] Section 173 provides in part that

> all expenditures (other than expenditures for the purchase of land or depreciable property or for the acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine, or other periodical) to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical shall be allowed as a deduction . . . .

E. Summary.

Under a proper interpretation of Treas. Reg. § 1.167(a)-3, the initial paid subscribers fall within the first sentence of the regulation and cannot be "goodwill" because they have reasonably determinable useful lives. If the regulation were to be interpreted as the Third Circuit urges, its simple sentence about "goodwill" would become, as applied to the facts of this case, a singular exception to the basic rule of the statute mandating a depreciation allowance for a wasting asset. If an exception had been intended, one would have expected the regulation to state so explicitly. Furthermore, in the absence of any statutory or regulatory hint that the sentence concerning "goodwill" is an exception to the basic rule, a construction that interprets that sentence as an exception should be avoided because it would be totally inconsistent with the statute and the section 167(a) regulations.[7]

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[7] NAA believes that the Commissioner's interpretation of Treas. Reg. § 1.167(a)-3 would render the regulation invalid. Such an interpretation would prevent the depreciation of an asset having a reasonably ascertainable useful life, and would therefore restrict the allowance for depreciation mandated by Congress. *See, e.g., Niagara Falls Brewing Co. v. Commissioner*, 38 F.2d 217, 220 (2d Cir. 1929), *aff'd*, 282 U.S. 648 (1931) (Treasury regulation regarding depreciation "created an additional burden upon the taxpayer, not provided for by the statute, and is unlawful."); *Estate of Boeshore v. Commissioner*, 78 T.C. 523, 527 (1982) (Treasury regulation "may not usurp the authority of Congress by adding restrictions to a statute which are not there."). This Court should avoid a construction of Treas. Reg. § 1.167(a)-3 "which raises doubt as to the validity of the regulation." *Northern Natural Gas*, 277 F.2d at 134; *see also Southland Royalty Co. v. Federal Energy Admin.*, 512 F. Supp. 436, 446 (N.D. Tex. 1980) ("If an agency is powerless to create regulations which conflict with Congressional intent, then it follows that an agency is equally powerless to interpret an existing regulation in such a way as to cause consequences inconsistent with the purpose of the enabling act, and that such an interpretation is a nullity.") (citing *Federal Maritime Comm. v. Seatrain Line*, 411 U.S. 726 (1973)); *Bhada v. Commissioner*, 89 T.C. 959, 972-73

Although this case involves the interpretation of Treasury Department regulations by the Commissioner, a court "must reject an administrative interpretation when there are compelling indications that it is wrong." *Collums v. United States*, 480 F. Supp. 864, 869 (D. Wyo. 1979) (citing *Espinoza v. Farah Mfg. Co.*, 414 U.S. 86, 94-95 (1973) and other cases); *see also Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 381 (1969); *United Fire Insurance Co. v. Commissioner*, 768 F.2d 164, 169 (7th Cir. 1985).[8] The Commissioner's interpretation of Treas. Reg.

(1987), *aff'd*, 892 F.2d 39 (6th Cir. 1989) (interpreting Treasury regulation to avoid construction that would bring into question the validity of the regulation).

[8] This is not a case in which the Commissioner is entitled to heightened deference by virtue of the "legislative reenactment" doctrine. The legislative reenactment doctrine does not apply here for a number of reasons. First, although Treas. Reg. § 1.167(a)-3 may be long-standing, the Commissioner's current interpretation of the regulation is not. The Commissioner's interpretation of Treas. Reg. § 1.167(a)-3 (that a wasting intangible asset may constitute non-depreciable "goodwill" even though it has a limited useful life and an ascertainable value) is a relatively recent position. Where an interpretation of a regulation has been neither "uniform" nor "long-standing," the legislative reenactment doctrine does not apply. *See, e.g., Iselin v. United States*, 270 U.S. 245, 251 (1926). By contrast, prior to this case, authority existed for the position that an intangible asset with a limited useful life could *not* constitute non-depreciable "goodwill". *See, e.g., Richard S. Miller & Sons*, 537 F.2d at 454 ("[a]n intangible asset is separate and distinct from goodwill when its useful life can be shown with reasonable accuracy to be of limited duration."); *Colorado National Bankshares*, 60 T.C.M. at 789 (rejecting Commissioner's interpretative position that even if taxpayer "has established a 'life' and a 'value' for core deposits intangible, we must still inquire whether it is, in essence, goodwill"). Second, the legislative reenactment doctrine does not apply here because there is no indication that Congress has ever focused on the Commissioner's interpretation. *See United States v. Calamaro*, 354 U.S. 351, 359 (1957) (where reenactment of tax legislation was not accompanied by any discussion of regulation at issue, reenactment was "without significance"). Finally, because the Commissioner's interpretation of Treas. Reg. § 1.167(a)-3 is erroneous, the legislative reenactment doctrine is inapplicable. *See,*

§ 1.167(a)-3 (which was adopted by the Third Circuit) is inconsistent with the statutory mandate of section 167(a), the Treasury's own regulatory scheme under the section 167(a) regulations, and the purpose of the statute and regulations. Accordingly, there are "compelling indications" that the Commissioner's interpretation of Treas. Reg. § 1.167(a)-3 is wrong and should be rejected.

II. THE INITIAL PAID SUBSCRIBERS ARE ANALOGOUS TO PATENTS AND SHOULD BE TAXED SIMILARLY.

An additional indication that the Commissioner's interpretation of Treas. Reg. § 1.167(a)-3 is wrong can be found within the four corners of Treas. Reg. § 1.167(a)-3 itself. Treas. Reg. § 1.167(a)-3 provides that "goodwill" is not depreciable. Although what constitutes "goodwill" within the meaning of Treas. Reg. § 1.167(a)-3 has been the source of enormous confusion and uncertainty, the regulation itself provides guidance concerning the proper interpretation of the term. Specifically, it provides that a patent may be depreciated. The economic and tax characteristics of a patent are straighforward. If another asset shares those same economic and tax characteristics, that is a strong indication that under the policy of Treas. Reg. § 1.167(a)-3, the other asset should also be depreciable. Put another way, because a patent is not included in "goodwill", Treas. Reg. § 1.167(a)-3 should be interpreted so that any asset that shares a patent's characteristics is likewise not included in "goodwill".

The initial paid subscribers are in all material ways directly analogous to patents. First, the price that a purchaser is willing to pay for a patent is invariably based upon the future income that the patent is expected to gen-

e.g., Clifford v. Helvering, 105 F.2d 586, 591 (8th Cir. 1939), *rev'd on other grounds*, 309 U.S. 331 (1940) (rejecting a "plainly erroneous" construction despite legislative reenactment). *See generally* 1 *Mertens Law of Federal Income Taxation* §§ 3.89 to 3.97 (1992).

erate. The future income ordinarily depends on the expected future sales of products that are manufactured using the patent; those sales need not be generated under any pre-existing contracts. In short, the price that a purchaser is willing to pay for a patent depends on the expectation of future patronage. Similarly, the portion of the purchase price of a newspaper that is attributable to the paid subscribers is based upon the expectation of future patronage.

Second, a patent has a limited useful life in the business. The term of a patent generally extends for a period of 17 years, or up to 14 years in the case of a design patent. 35 U.S.C. §§ 154, 173. The statutory life of the patent establishes a maximum useful life, but taxpayers are allowed to prove a shorter useful life. Treas. Reg. §§ 1-167(a)-1(b), 1-167(a)-3, and 1.167(a)-6(a).[9] Similarly, the initial paid subscribers have limited use-

[9] Treas. Reg. § 1.167(a)-6(a) specifies that a patent is to be depreciated over its remaining useful life. Treas. Reg. § 1.167(a)-3 also states that if an intangible asset is known from experience or other factors to be of use in the taxpayer's trade or business for only a limited period, and that length of time can be estimated with reasonable accuracy, then the intangible asset may be the subject of a depreciation allowance. Patents are specifically mentioned in the regulation. Treas. Reg. § 1.167(a)-1(b) further states that the useful life of an asset is not necessarily the useful life inherent in the asset (in the case of patents, generally 17 years), but rather may be the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business. Accordingly, a taxpayer is entitled to prove that a patent has a shorter useful life than the the remaining legal life of the patent. *See Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979, 986 (1945), *acq.*, 1959-2 C.B. 3 (adopting depreciation method with respect to patent in which taxpayer is entitled to depreciation deduction only in years that patent earns income; rejecting Commissioner's contention that each payment must be capitalized and then prorated over the remaining legal life of the patent); Rev. Rul. 67-136, 1967-1 C.B. 58 (agreeing to follow *Associated Patentees* decision); *see also* Petry, M., *Taxation of Intellectual Property* ¶ 3.18, at 3-64 to 3-67 (1991); Cross, J., 209-4th Tax Management Portfolios, *Purchase Price Allocation and Amortization of Intangibles* A-35 (1991).

ful lives in the business, as the Third Circuit itself admitted. Pet. App. at 29a.

Third, the costs of creating a patent through one's own efforts are generally deductible under section 174(a). That Code provision allows a taxpayer to deduct "research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business . . . ." Such expenditures incurred in creating a patent qualify for the current deduction under section 174(a). Alternatively, in lieu of claiming a current deduction under section 174(a), a taxpayer may elect generally to treat such expenditures as deferred expenses which are deductible ratably over a period of not less than 60 months. Section 174(b). Similarly, section 173 allows a taxpayer to deduct the costs of establishing, maintaining, or increasing the circulation of a newspaper. Alternatively, in lieu of taking a current deduction for circulation expenditures under section 173, a taxpayer may elect to capitalize that portion of the circulation expenditures which is properly chargeable to capital account. Section 173(a); Treas. Reg. § 1.173-1(c)(1). Moreover, for purposes of computing a taxpayer's alternative minimum tax, the deductions under sections 173 and 174 are often treated in a similar manner (and in some cases within the same subparagraph of a Code section).[10]

Fourth, the costs of purchasing a patent from a third party are not deductible, but instead must be capitalized. *See* Treas. Reg. § 1.174-2(a)(1) (providing in part that "research or experimental expenses" do not include "the costs of acquiring another's patent"). Similarly, section 173 does not allow a current deduction for the purchase

[10] *See* section 56(b)(2) (requiring individuals to capitalize for alternative minimum tax purposes amounts allowable as a deduction under sections 173 and 174(a)); section 59(e) (election to capitalize amounts allowable as a deduction under sections 173 and 174(a) for regular tax purposes and avoid alternative minimum tax adjustment).

of newspaper subscribers. *See* Rev. Rul. 74-103, 1974-1 C.B. 62; Treas. Reg. § 1.173-1(a)(1).

Fifth, when the creator of a patent sells all substantial rights to it, the creator is generally eligible for capital gain treatment under either section 1221, 1231, or 1235. When the owner of a newspaper sells it, the gain attributable to the paid subscribers is generally treated as capital gain under either section 1221 or 1231.

The above analysis shows that patents and the initial paid subscribers have essentially identical tax and economic characterizations. Accordingly, they should be treated the same for purposes of Treas. Reg. § 1.167(a)-3. Because the cost of acquiring a patent from a third party is depreciable over the useful life of the patent (*see Newton Insert Co. v. Commissioner*, 61 T.C. 570, 586 (1974), *aff'd per curiam*, 545 F.2d 1259 (9th Cir. 1976); Treas. Reg. § 1.167(a)-6(a)), so should the cost of acquiring the initial paid subscribers from a third party be depreciable over the useful lives of such subscribers.

III. NEWSPAPER SUBSCRIBERS CANNOT BE ANALYZED SIMPLY AS CUSTOMERS.

The foregoing portions of this brief conclude that for purposes of Treas. Reg. § 1.167(a)-3, the initial paid subscribers should be treated as a depreciable intangible asset pursuant to the first sentence of the regulation and "goodwill" should be interpreted to include only assets with indeterminate useful lives. Under that interpretation, the initial paid subscribers would not constitute nondepreciable "goodwill". NAA believes that no further analysis is required.

But even if this interpretation is rejected and "goodwill" is interpreted more broadly to refer to customers in some way, the initial paid subscribers would still not constitute "goodwill". This is because their primary value to a newspaper comes not from their status as customers

of the newspaper, but from the newspaper's ability to use the subscribers to attract advertising.

The Third Circuit analyzed the depreciability of the paid subscribers as if the value of the initial paid subscribers arose only from their status as customers of the newspapers. It stated:

> *Customer* lists are generally not amortizable when acquired in conjunction with a sale of the underlying business as a going concern. In the context of the sale of a going concern, it is simply often too difficult for the taxpayer and the court to separate the value of the list *qua* list from the goodwill value of the *customer* relationship/structure. [Pet. App. at 29a; emphasis added.]

This paragraph shows that the Third Circuit approached the initial paid subscribers only as customers of the newspapers. Because it did so, it concluded that the value of the subscribers was inextricably linked with "goodwill" and therefore nondepreciable.

Treating the subscribers to a newspaper as only customers, and as no other source of value, misapprehends the nature of newspaper subscribers. In a typical daily newspaper, perhaps 70 percent to 80 percent of the revenue comes from advertisers. For the newspapers at issue in this particular case, approximately 80 percent of their total revenue came from sales of advertising. Pet. App. at 38a; *see also Donrey, Inc. v. United States*, 809 F.2d 534, 535-36 (8th Cir. 1987) (evidence indicated that 80 percent of newspaper's total revenues came from advertising). Advertisers use a newspaper because it enables them to reach the readers of the newspaper. In a real sense, the initial paid subscribers are not only customers of the newspaper, but even more importantly are customers (or intended customers) of the newspaper's advertisers, who are willing to pay significant sums to the newspaper to obtain access to the subscribers. Accordingly, it is incorrect to analyze the paid subscribers only

as "customers" of the newspaper. They are a tool that the newspaper uses to attract most of its revenues from its real customers.

Because newspaper subscribers are more than "customers", the value of the initial paid subscribers is not properly attributable to what the Third Circuit meant by "goodwill".

NAA acknowledges that the particular valuation method primarily used by Petitioner's experts valued the initial paid subscribers according to the incremental subscription revenues that they generate. However, it is possible to value the initial paid subscribers using other income methods that are not keyed solely to subscription revenues. These alternative approaches instead value the subscribers as a function of the advertising revenues that they generate. Petitioner's own expert used such a method as an alternative in this case (see Pet. App. at 46a), and other NAA members have used similar methods. Thus, the particular income valuation approach chosen by this particular taxpayer does not negate the fact that the initial paid subscribers are more than mere "customers" of the newspaper.

CONCLUSION

The interpretation of Treas. Reg. § 1.167(a)-3 adopted by the Third Circuit conflicts with the statutory mandate of a depreciation allowance for wasting assets, the regulatory scheme under section 167(a), and the words of Treas. Reg. § 1.167(a)-3 itself. NAA urges this Court to interpret Treas. Reg. § 1.167(a)-3 in a way that is consistent with the statutory mandate and the Treasury's own regulations.

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Supreme Court of the United States

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NEWARK MORNING LEDGER COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA,
RESPONDENT

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF FOR BLACK & DECKER CORPORATION, BRUNSWICK CORPORATION, INTERNATIONAL MULTIFOODS CORPORATION, AND NESTLÉ USA, INC., AS AMICI CURIAE IN SUPPORT OF PETITIONER

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BRIEF FOR BLACK & DECKER CORPORATION, BRUNSWICK CORPORATION, INTERNATIONAL MULTIFOODS CORPORATION, AND NESTLÉ USA, INC., AS AMICI CURIAE IN SUPPORT OF PETITIONER

Pursuant to Rule 37.3 of the Rules of this Court, this brief is respectfully submitted in support of petitioner by *amici curiae* Black & Decker Corporation, Brunswick Corporation, International Multifoods Corporation, and Nestlé USA, Inc. The parties have consented to the filing of this brief, and their written consents have been filed with the Clerk of the Court.

INTEREST OF THE AMICI CURIAE

Black & Decker Corporation is a manufacturer and marketer of consumer and commercial products such as power tools, accessories, and small household appliances. Brunswick Corporation is a manufacturer and marketer of prod-

ucts serving leisure markets in marine power, pleasure boating, and recreation, as well as selected defense and industrial technology sectors. International Multifoods Corporation is a diversified food company principally engaged in the manufacture and distribution of food products for the foodservices industry. Nestlé USA, Inc., is a manufacturer and distributor of food products. Each of these companies currently is engaged in a dispute with the Internal Revenue Service concerning the depreciability of intangible assets, and therefore they have a substantial interest in the Court's resolution of the question presented in this case.

INTRODUCTION AND SUMMARY OF ARGUMENT

Until the Third Circuit's decision in this case, settled law held that the depreciability of an intangible asset was a question of fact dependent on the particular circumstances presented and could not be resolved as a matter of law. Nevertheless, and notwithstanding that the Internal Revenue Service itself adopted that position in its most recent revenue ruling on the depreciability of intangible assets, the Service now argues that certain intangibles are not depreciable as a matter of law because their inherent nature renders them nondepreciable goodwill. The courts squarely rejected this argument when it was first advanced 20 years ago, and they consistently have rejected it ever since. The government cannot cite a single decision (other than that below) to support its contention that the depreciability of an intangible asset is controlled by a *per se* legal rule regardless of the facts and circumstances demonstrated at trial. Indeed, in this very case, the government "*concede[d]*" in the district court that the issue of depreciation "is a factual one" (Pet. App. 32a (emphasis added)) but then abandoned that concession on appeal in the face of Judge Sarokin's adverse findings of fact.

The essential premise of the government's argument is that certain intangible assets intrinsically are (or are part of) goodwill and can be so determined as a matter of law even though the facts and circumstances at trial establish—as the district court expressly found here, and the court of appeals did not disturb—that the asset has both a reasonably determinable limited useful life and an ascertainable value. Because IRS regulations specifically state that goodwill is not depreciable, the government reasons, assets that "quintessentially" (Pet. App. 3a) partake of or contribute to goodwill cannot be depreciated. The government's quest for a Platonic form of goodwill is futile and offers no workable standard for the administration of the tax code.

As Congress, the IRS, and the courts long have recognized, the defining characteristic of goodwill is that it has an indefinite life, and therefore it does not qualify for a depreciation deduction. Conversely, an intangible asset that, like petitioner's "paid subscribers," has a determinable limited useful life is not goodwill and, if a value can reasonably be ascertained, is depreciable. Simply put, an intangible asset that can (in the parlance of appraisers) be "lifed and valued" is not goodwill.

This concept of goodwill based on indefinite useful life is inherent in the tax statute and IRS regulations. Furthermore, unlike the government's proposed approach, it provides a practicable rule for applying the depreciation deduction. Although the government refers to goodwill in terms of the expectancy that existing customers will continue to patronize a business, that is only one of several different formulations found in the cases and was designed merely to explain the abstraction of goodwill in an intuitive and understandable way. It is a description, not a definition, and does not serve as an operable legal standard that can be rigorously and consistently applied in practice to resolve particular cases. Finally, the govern-

ment's approach is internally flawed; a number of intangible assets (for example, patents for popular products) could be said to contribute to continued customer patronage and thus be encompassed in goodwill, but nonetheless such assets unquestionably are depreciable (indeed, the IRS's regulation explicitly states that patents are depreciable, see 26 C.F.R. § 1.167(a)-3). In the end, it is the concept of determinable limited useful life that provides a meaningful legal standard to separate depreciable intangible assets from nondepreciable goodwill.

Over time, the experience under the tax code has been that additional categories of intangible assets have become depreciable as appraisal techniques for lifing and valuing them have improved. This evolution reflects not a change in the tax law but advancements in the appraisers' art that permit a life and value to be determined, based on all the relevant facts and circumstances, for an ever-increasing array of intangibles. Because the federal income tax is a tax on *net* income, this trend toward depreciation of more intangible assets accords with sound tax policy by better matching annual income with the costs (including the depreciation of wasting intangibles) incurred in that year in producing the income. Moreover, such treatment also is consistent with modern accounting rules both in this country and abroad, which emphasize the importance of depreciation of intangible assets to a fair statement of net annual income.

The government expresses the concern that this evolutionary improvement in the accuracy with which actual net income is determined has reduced the scope of nondepreciable goodwill. However, that concern not only provides no answer to the legal analysis supporting the "facts and circumstances" test for determining limited useful life, but it also ignores sound tax and accounting policies. If the government wishes to abandon the prevailing standard, substituting instead a rule of nondepreciability as a matter of law, it should ask Congress to amend the tax

code—something Congress specifically declined to do when it considered such a proposal in 1987.

ARGUMENT

AN INTANGIBLE ASSET THAT, AS A FACTUAL MATTER, HAS A DETERMINABLE LIMITED USEFUL LIFE AND A REASONABLY ASCERTAINABLE VALUE MAY BE DEPRECIATED

I. AN INTANGIBLE ASSET THAT, BASED ON ALL THE FACTS AND CIRCUMSTANCES, HAS A DETERMINABLE LIMITED USEFUL LIFE IS NOT GOODWILL AND IS SUBJECT TO DEPRECIATION

In this case the IRS disallowed petitioner's claimed depreciation deduction for its intangible asset of "paid subscribers" on the ground that the asset was "quintessentially goodwill" (Pet. App. 3a) and therefore nondepreciable. As a matter of law, according to the Service, it is not enough for the taxpayer to "demonstrate a reasonable estimate of useful life and an ascertainable value in order to depreciate a purchased intangible asset"; in addition, the taxpayer also must overcome "the fundamental legal hurdle" of establishing "that the asset *is not goodwill*." *Id.* at 7a. In the IRS's view, the "paid subscribers" asset "is the very essence of * * * goodwill" (*ibid.*) and hence nondepreciable as a matter of law.

Following a bench trial, the district court rejected the IRS's argument. It specifically made findings of fact that petitioner "has met its burden" of proving that its "subscribers had limited useful lives, the duration of which can be estimated with reasonable accuracy, and ascertainable values separate and apart from goodwill." Pet. App. 32a. Based on those findings, the court held that petitioner was entitled to a depreciation deduction.

Without setting aside these findings, the court of appeals reversed the district court's decision and sustained

the IRS's disallowance. It agreed with the Service "that, for tax purposes, there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." Pet. App. 29a. Such assets, the court held, "are generally not depreciable when acquired in conjunction with the sale of the underlying business as a going concern." *Ibid.*

The Third Circuit's holding cannot withstand analysis. Under a proper interpretation of the tax code, the touchstone of a depreciable intangible asset—and the dividing line between such an asset and nondepreciable goodwill—is the existence of a determinable limited useful life and a reasonably ascertainable value. Thus, it is an oxymoron to say, as the court of appeals did, that an asset is nondepreciable goodwill even though it can be lifed and valued. Rather, an intangible asset that has a determinable life and value based on all the relevant facts and circumstances is subject to depreciation, and no rule of law requires that it be treated as nondepreciable goodwill.

A. Under The Tax Statute And IRS Regulation, Depreciability Of An Intangible Asset Is Premised On The Concept Of Determinable Limited Useful Life

"[T]hat the federal income tax is a tax on net income * * * has been firmly imbedded in the tax statute from the beginning." *Commissioner* v. *Tellier*, 383 U.S. 687, 691 (1966); see also *id.* at 691-692 (quoting legislative history). "It is clear that the Congress intended the income tax laws 'to tax earnings and profits less expenses and losses,' carrying out a broad basic policy of taxing 'net, not . . . gross, income.' " *Tank Truck Rentals* v. *Commissioner*, 356 U.S. 30, 33 (1958) (citations omitted). To provide an accurate measure of net income on an annual basis, "the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable." *INDOPCO, Inc.* v. *Commissioner*, 112 S. Ct. 1039, 1043 (1992).[1]

The depreciation deduction is an integral element of the statutory scheme for determining net income. See *INDOPCO*, 112 S. Ct. at 1042-1043. As the Court explained in *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 10-11 (1974) (citations omitted):

> [Under the depreciation deduction], the asset's adjusted income tax basis is reduced to reflect the distribution of its cost over the accounting periods affected. * * * "[T]he purpose of depreciation accounting is to allocate the expense of using an asset to the various periods which are benefited by that asset." When the asset is used to further the taxpayer's day-to-day business operations, the periods of benefit usually correlate to the production of income. Thus, to the extent that [the asset] is used in such operations, a current depreciation deduction is an appropriate offset to gross income currently produced.

The depreciation deduction thus reflects the fact that "[t]he gain or loss in any year cannot be rightly ascertained without taking into account the amount of such [depreciation] cost that is justly attributable to that period of time. * * * [An] annual allowance for [depreciation] * * * is necessary in order to determine true gain or loss because postponement of deductions to cover [depreciation] * * * would distort annual income." *Gambrinus Brewery Co.* v. *Anderson*, 282 U.S. 638, 643, 645 (1931). Accordingly, the "primary purpose" of depreciation is to allocate "the cost entailed in the use * * * of the asset to the periods to which it contributes" (*Massey Motors* v. *United*

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[1] In rare instances, specifically identified deductions are disallowed for reasons of public policy. See *Tellier*, 383 U.S. at 691, 693 & n.10. No such express provisions or policy grounds exist here to require the denial of depreciation of intangible assets. On the contrary, as discussed in the accompanying text and below (see pages 23-24, *infra*), sound tax policy supports depreciation of intangibles that have a limited useful life and ascertainable value.

States, 364 U.S. 92, 104 (1960)) in order to "reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets." *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 101 (1943).

From the inception of the modern tax code in the Revenue Act of 1913, Congress has provided a depreciation deduction for "the exhaustion," "wear and tear," and (as added in 1918) "obsolescence" of business property. See 26 U.S.C. § 167(a);[2] Revenue Act of 1913, 38 Stat. 114, 172; *Haberle Crystal Springs Brewing Co.* v. *Clarke*, 30 F.2d 219, 220 (2d Cir. 1929) (discussing statutory history), rev'd, 280 U.S. 384 (1930). Congress's use of these terms clearly indicates its focus on the useful life of the asset to the taxpayer as the basis for the depreciation deduction. As then-Judge Blackmun explained, the plain language of the statute requires that a depreciation deduction be available for an "asset [that is] an exhausting one." *Northern Natural Gas Co.* v. *O'Malley*, 277 F.2d 128, 139 (8th Cir. 1960) (Blackmun, J., concurring). Thus, "if the asset is shown to be a wasting one used in the taxpayer's trade or business, a reasonable deduction must be allowed." *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240, 1251 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974) (citing *Northern Natural Gas*).

Congress itself recently has indicated its understanding that depreciability of intangible assets turns upon the existence of a determinable limited useful life. In 1987, the House passed a bill that included a provision to deny depreciation for customer-based or market-based intangibles

[2] In its current form, Section 167(a) provides:

Depreciation

(a) **General rule.**—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

such as "paid subscriber" assets. Although other sections of the House bill were enacted into law in the Omnibus Budget Reconciliation Act of 1987 (Pub. L. No. 100-203, Title X, 101 Stat. 1330, 1330-382), the Conference Committee rejected the provision eliminating depreciation of these intangible assets. In thus declining to amend current law, the Conference Report summarized the prevailing law as follows:

> No such [depreciation] deductions are allowed * * * with respect to property that is not a wasting asset or property whose useful life cannot be estimated with reasonable accuracy. * * * *[B]ecause goodwill does not have a determinable useful life, no depreciation deduction is allowed with respect to that intangible asset.* Accordingly, the portion of the purchase price of a business that is allocated to goodwill may not be amortized or depreciated.

H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 936-937 (1987) (emphasis added). This expression of the congressional understanding of the law that was being retained is a telling indication of the meaning of that law. See *Fribourg Navigation Co.* v. *Commissioner*, 383 U.S. 272, 283-284 (1966); see also *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353, 378 (1982).

The history of the IRS's promulgations under the depreciation statute confirms that determinable limited useful life is the guiding criterion for depreciability. In 1918 the Service issued its first regulation on depreciation of intangible assets. That regulation provided:

> *Depreciation of Intangible Property.*—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in

> the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. There can be no such allowance in respect of good will, trade names, trade marks, trade brands, secret formulas, or processes.

Reg. 45, Art. 163 (1918), quoted in *Red Wing Malting Co.* v. *Willcuts*, 15 F.2d 626, 628 (8th Cir. 1926), cert. denied, 273 U.S. 763 (1927). Thus, the 1918 regulation allowed depreciation for intangible assets whose use was "limited in duration" or whose value would remain "for only a limited period." Read in this context, the final sentence—which disallowed depreciation for goodwill and other intangible assets that had indefinite lives—was but a logical corollary of the central principle that depreciation was allowable for intangible assets with determinable limited useful lives.

This reading is substantiated by the IRS's amendment to its regulation a year later. At that time the Service deleted the last sentence of the 1918 regulation on the nondepreciability of goodwill. T.D. 2929, 1 C.B. 133 (1919). As the IRS explained:

> [The 1918 regulation] states that "Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance." It is true that this same article states that no such allowance may be made in the case of intangibles of the class now under consideration [including goodwill], and while in general this negative decision is sound, *the controlling rule is the one quoted above, and when an item of intangible property falls within that rule it must be dealt with accordingly. [That is the] major rule laid down in [the 1918 regulation].* * * *
>
> *[W]hen it is demonstrated that the useful life of an intangible is definitely limited, such intangible then becomes a proper subject of depreciation allowance.*

T.B.R. 44, 1 C.B. 133, 134-135 (1919) (emphasis added). The 1919 regulation therefore made explicit what was implicit in the 1918 regulation: (1) the "major" and "controlling" rule is that intangible assets whose use is "limited in duration" are "a proper subject of depreciation," and (2) the statement disallowing a depreciation deduction for goodwill, while "in general * * * sound," was not an independent prohibition but rather derived from the preceding rule as applied to assets that had indefinite lives.

In 1927 the IRS again amended its regulation "[i]n view of the decision of the * * * Eighth Circuit" in *Red Wing Malting Co.* v. *Willcuts*, *supra*. See T.D. 4055, VI-2 C.B. 63 (1927). *Red Wing* held that the goodwill of a company involved in the production of liquor, even though limited in duration by the enactment of Prohibition, was not subject to a depreciation deduction for obsolescence because "there can be no wear or tear of good will, or exhaustion thereof by use[.] * * * [The statute] limits the allowance for [depreciation] to such property as is susceptible to exhaustion, wear, and tear by use in the business, and good will is not such property." 15 F.2d at 633. Thus, *Red Wing* did not involve the definition of goodwill but rather turned on whether goodwill fell outside the depreciation statute because it was not subject to exhaustion, wear, and tear.[3] In light of *Red Wing*'s holding that goodwill is not a wasting asset and hence is not depreciable, the IRS added the following sentence to its regulation:

> No deduction for depreciation, including obsolescence, is allowable in respect of good will.

T.D. 4055, VI-2 C.B. at 63.

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[3] This Court subsequently affirmed the *Red Wing* holding in *Clarke* v. *Haberle Crystal Springs Brewing Co.*, 280 U.S. 384, 386-387 (1930), but on the different ground that "Congress cannot be taken to have intended such a partial compensation to be provided for [through an abatement of taxes] by the words 'exhaustion' or 'obsolescence.' Neither word is apt to describe termination by law as an evil."

In substantially this form, the IRS's regulation on the depreciation of intangible assets has continued from 1927 to the present. See 26 C.F.R. § 1.167(a)-3.[4] As the IRS explained in its brief to the Third Circuit in this case (at 28 (emphasis added)), the "*basic premise of the Regulation [disallowing depreciation of goodwill is] that goodwill has an indeterminate useful life.*" See also Gregorcich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 TAX LAWYER 251, 253 (1975) ("The regulations thus settle on *limited useful life* as the essential requirement for amortization. Goodwill is viewed as having no ascertainable economic life apart from the business itself, and therefore, as having an indeterminate useful life"); Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 HARV. L. REV. 859, 863 (1968) ("Treasury Regulation 1.167(a)-3 * * * denies a [depreciation] deduction for goodwill on the ground that it does not have a determinable useful life estimable with reasonable accuracy").

This history demonstrates that the IRS's regulation distinguishes between depreciable intangible assets and nondepreciable goodwill on the basis of determinable limited useful life. If an asset is a wasting asset—in other words,

[4] In its current form, Section 1.167(a)-3 provides:

Intangibles.

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder. For rules with respect to trademark and trade name expenditures, see section 177 and the regulations thereunder.

if it is subject to exhaustion, wear, and tear—and its useful life is determinable, it is depreciable. That is the controlling rule embodied in the regulation. If, however, the asset is not subject to exhaustion or otherwise does not have a determinable life, then, under the reasoning of *Red Wing* as incorporated in the regulation, it is not depreciable. The amendment to the regulation following *Red Wing* served to make that conclusion clear, not to repudiate the general rule by establishing a freestanding prohibition that severed the depreciation deduction from useful life. The concept of determinable limited useful life is the compass that the tax law provides to navigate the uncharted reaches of depreciability.[5]

B. Uniform Case Law And The IRS's Own Non-Litigation Position Establish That A "Facts And Circumstances" Test Governs Depreciability

With the singular exception of the Third Circuit's ruling in this case, judicial decisions consistently have recognized that the issue whether an intangible is a depreciable asset or nondepreciable goodwill raises a question of fact to be determined on the particular circumstances presented and cannot be resolved as a matter of law. For example, in *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987), the court of appeals held that the acquired subscriber list of a newspaper—which is indistinguishable from petitioner's "paid subscribers" asset in this case—was depreciable. In affirming a jury verdict in favor of the taxpayer on the depreciation issue, the court stressed that "[e]ntitlement to a depreciation allowance for an intangible asset is a question of fact." *Id.* at 536. The uniform holdings of other circuits, as well as the Court of

[5] This reading also comports with the basic principle of administrative law that an agency's regulation should be construed to "harmonize[ ] with the plain language of the statute" under which it was promulgated. *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477 (1979).

Claims and the Tax Court, are to the same effect. See, *e.g.*, *Citizens & Southern Corp.* v. *Commissioner*, 919 F.2d 1492 (11th Cir. 1990) (*per curiam*), aff'g upon the opinion below 91 T.C. 463, 479 (1988) (depreciability "is essentially a factual question"); *Houston Chronicle*, 481 F.2d at 1245-1251, 1253 ("amortizability for tax purposes must turn on factual bases"); *Richard S. Miller & Sons, Inc.* v. *United States*, 537 F.2d 446, 452 (Ct. Cl. 1976) ("[e]ntitlement to a depreciation allowance is a question of fact"); *IT&S of Iowa, Inc.* v. *Commissioner*, 97 T.C. 496, 508 (1991) ("[w]hether such requirements have been met is essentially a question of fact," and the "inquiry is primarily factual"); *Colorado National Bankshares, Inc.* v. *Commissioner*, 60 T.C.M. (CCH) 771, 787, 788 (1990) (same). Thus, as the General Accounting Office recently summarized in a report to the congressional Joint Committee on Taxation, the issue of depreciability is decided "on the basis of facts and circumstances" on a "case-by-case basis." United States General Accounting Office, Report to the Joint Committee on Taxation, *Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets* 2, 39 (Aug. 1991).[6]

In adopting a "facts and circumstances" test, the courts have made clear that the depreciability of intangible assets cannot be decided as a matter of law. As the court explained in *Richard S. Miller & Sons*, 537 F.2d at 452:

[6] Therefore, as in *Fribourg Navigation Co.*, our interpretation finds strong "support among * * * lower federal courts that have recently dealt with this issue," including "the Tax Court itself." 383 U.S. at 287. Indeed, because of the Tax Court's special expertise and extensive experience in applying the code, its views should be accorded deference. See *United States* v. *Foster Lumber Co.*, 429 U.S. 32, 55 (1976) (Blackmun, J., dissenting); *Arrowsmith* v. *Commissioner*, 344 U.S. 6, 12 (1952) (Jackson, J., dissenting). This Court so held under a predecessor version of the tax code (see *Trust of Bingham* v. *Commissioner*, 325 U.S. 365, 371 (1945); *id.* at 379-381 (Frankfurter, J., corcurring); *Dobson* v. *Commissioner*, 320 U.S. 489, 498-499 (1943)), and the practical reasons supporting that conclusion remain equally applicable today.

> Entitlement to a depreciation allowance is a question of fact and not of law.
>
> There is no per se rule of nondepreciability or non-amortizability in every case that involves both goodwill and other intangible assets. The depreciability of [such] assets * * * is a factual question only.

See also, *e.g.*, *Houston Chronicle*, 481 F.2d at 1248-1249, 1253 ("[w]e reject * * * the establishment of a *per se* rule * * * that would amalgamate all subscription lists with goodwill"); *Citizens & Southern*, 91 T.C. at 483 (rejecting the argument that an intangible asset is "as a matter of law the equivalent of goodwill and, therefore, not depreciable"). In particular, the Eighth Circuit in *Donrey* rejected the IRS's argument that a newspaper's customer subscription structure and list were "part of the goodwill * * * [and accordingly] not depreciable as a matter of law." 809 F.2d at 535.[7]

The analytical foundation for this line of authority is the cardinal principle, embodied in the depreciation statute and regulation (see pages 8-13, *supra*), that an intangible asset of determinable limited useful life is subject to depreciation. By contrast, goodwill is deemed under the

[7] The demise of the so-called "mass asset rule" also demonstrates that depreciability cannot be adjudicated as a matter of law. The mass asset rule treated certain intangible assets such as customer lists as a self-regenerating collective whole that was not depreciable because it had no determinable limited useful life. As the Third Circuit recognized (Pet. App. 14a, 16a), the mass asset rule is "now outdated" and was "inter[red]" by *Houston Chronicle*, which rejected the concept and held that there is no "*per se* rule of non-amortizability in every case involving both goodwill and other intangible assets. * * * We reject * * * a monolithic 'mass asset' theory that would amalgamate all subscription lists with goodwill." 481 F.2d at 1249-1250, 1253. As its brief in the Third Circuit (at 29) makes evident, the government's position here is a thinly veiled effort to revive the discredited mass asset theory. See also *Citizens & Southern*, 91 T.C. at 482 ("it appears that [the Commissioner] is urging us to apply the 'mass asset' rule although he does not articulate his position as such").

tax law to have an indefinite useful life (see, *e.g.*, *Richard S. Miller & Sons*, 537 F.2d at 450; *IT&S*, 97 T.C. at 509; *Colorado National Bankshares*, 60 T.C.M. (CCH) at 789) and is excluded from depreciation precisely for that reason. See H.R. Conf. Rep. No. 495, at 936-937 (quoted at page 9, *supra*); Rev. Rul. 74-456, 1974-2 C.B. 65, 66 (quoted at page 19, *infra*); *Houston Chronicle*, 481 F.2d at 1248 & n.5; *Red Wing*, 15 F.2d at 633; Gregorcich, 28 TAX LAWYER at 253; Note, 81 HARV. L. REV. at 859; Gov't C.A. Br. at 28 (quoted at page 12, *supra*). Thus, the pivotal distinction between a depreciable intangible and nondepreciable goodwill is whether the asset has a determinable limited useful life:

> The most significant indication that an intangible asset is separate and distinct from goodwill is whether its useful life can be shown with reasonable accuracy to be of limited duration. The most important criterion is whether in fact it is a wasting asset.

Richard S. Miller & Sons, 537 F.2d at 452; see also, *e.g.*, *Houston Chronicle*, 481 F.2d at 1248 & n.5; *Colorado National Bankshares*, 60 T.C.M. (CCH) at 790. As the GAO recently concluded:

> Intangible asset costs can be amortized over the assets' useful lives if the assets can be separately identified and valued and if their specific useful lives can be determined. * * * Amortization is not allowed, however, for intangible assets like goodwill that do not have determinable useful lives.

GAO Report at 10.[8]

[8] Consistent with these settled precepts, the IRS conceded in the district court in this case that the issue of depreciability was one of fact. Only after the district court found the facts in favor of petitioner did the government switch to the argument on appeal that the "paid subscribers" asset was nondepreciable as a matter of law. See page 2, *supra*; see also *Donrey*, 809 F.2d at 537 (criticizing similar change in IRS's litigating position between trial and appeal).

Against this background, it becomes clear why the prevailing "facts and circumstances" test is—and must be—the applicable standard for the depreciability of intangible assets. Under the tax law, the dispositive determination is whether a limited useful life can be determined, which necessarily is factual in nature and must be based on the particular circumstances presented. If the taxpayer satisfies the burden (see *United States* v. *General Dynamics Corp.*, 481 U.S. 239, 245 (1987)) of proving a limited useful life in light of all the facts and circumstances, the asset is not goodwill and is subject to depreciation. As this Court has recognized in analogous situations, a "facts and circumstances" test is appropriate where "each case 'turns on its special facts' " (*INDOPCO*, 112 S. Ct. at 1044 (citation omitted)) and provides the "flexibility * * * necessary * * * to accommodate * * * the congressional intent to tax only net income." *Tank Truck Rentals*, 356 U.S. at 35. See also, *e.g.*, *Anderson* v. *Bessemer City*, 470 U.S. 564, 573-576 (1985) (discussing trier's institutional advantages in fact-finding and the significant deference appellate courts owe the trier's findings).

Of course, for depreciation to be claimed and computed, the taxpayer must demonstrate that an intangible asset has not only a determinable limited useful life but also a reasonably ascertainable value.[9] Although the valuation issue will be addressed below (see pages 28-30, *infra*), it

[9] The statute and regulation provide a "*reasonable* allowance" (26 U.S.C. § 167(a) (emphasis added)) for depreciation of an asset with a limited useful life "the length of which can be estimated with *reasonable* accuracy." 26 C.F.R. § 1.167(a)-3 (emphasis added). This standard of reasonableness is satisfied by "a rough estimate" (*United States* v. *Ludey*, 274 U.S. 295, 302 (1927)) or "reasonable approximation" that would be sufficient to "support a verdict for a plaintiff in an ordinary action for the recovery of money." *Burnet* v. *Niagara Falls Brewing Co.*, 282 U.S. 648, 654-655 (1931). As this Court has recognized, "there is a risk of error in such projections [of an asset's life and value], but prediction is the very essence of depreciation accounting." *Massey Motors*, 364 U.S. at 105.

may be observed at this point that these two elements—life and value—are encapsulated in the two-part standard of *Houston Chronicle* that has become the black-letter test for the depreciability of intangible assets (481 F.2d at 1251):

> [Under] § 167(a) of the Code and the Regulations promulgated thereunder, * * * [intangible assets] may be depreciated for tax purposes if taxpayer sustains his burden of proving that [they] (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy.

If an asset has a determinable useful life and ascertainable value, it necessarily is, for the reasons discussed above, "separate and distinct" from goodwill and thus depreciable. As the court correctly concluded in *Richard S. Miller & Sons* (537 F.2d at 454), "[a]n intangible asset is separate and distinct from goodwill when its useful life can be shown with reasonable accuracy to be of limited duration." See also *Citizens & Southern*, 91 T.C. at 515 (Cohen, J., concurring) (there is "no authority for the proposition that assets * * * are not separate and distinct from goodwill unless no part of their value is related to continued patronage of customers of an ongoing business"); GAO Report at 20 ("[t]he courts determine whether specific intangible assets are separate from goodwill and thus entitled to amortization if they have a determinable useful life and value").[10]

[10] The origin of the phrase "separate and distinct" is uncertain. It does not appear in either § 167 of the tax code or regulation 1.167(a)-3. As indicated in the text, the term is used in *Houston Chronicle* (and incorporated from that decision in Revenue Ruling 74-456). However, as this Court has cautioned, "the language of an opinion is not always to be parsed as though we were dealing with language of a statute." *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 341 (1979). In fact, *Houston Chronicle* used the term in the context of holding that the mass asset rule (see page 15 note

(Footnote continued on following page)

The IRS itself has officially adopted the "facts and circumstances" test of *Houston Chronicle*, disavowing the position—now resurrected in this litigation—that nondepreciability can be determined as a matter of law. In 1974, following the Fifth Circuit's decision in *Houston Chronicle* and this Court's denial of certiorari, the IRS issued Revenue Ruling 74-456 to reconsider two earlier revenue rulings on the depreciation of intangible assets. The Service explained that intangible assets such as goodwill that "have indeterminable lives * * *, *therefore*, are not subject to depreciation," but that an asset that "does not possess the characteristics of goodwill * * * and is of use to the taxpayer in its trade or business for only a limited period of time" is depreciable. In light of that principle, the Service "modified" the prior revenue rulings "*to remove any implication* that customer and subscription lists, location contracts, insurance expirations, etc., *are, as a matter of law, indistinguishable from goodwill possessing no determinable useful life.*" Rather, citing the two-part *Houston Chronicle* standard, the IRS expressly acknowledged that "*[t]he depreciability of assets of this nature is a factual question.*" Rev. Rul. 74-456, 1974-2

[10] *continued*

7, *supra*) did not bar depreciability if the asset had "an ascertainable value separate and distinct from goodwill" and therefore was not " 'inextricably' linked to goodwill." 481 F.2d at 1249, 1250. The phrase "separate and distinct" also is found in *Red Wing* in holding that goodwill was not a wasting asset subject to depreciation or obsolescence "even should we assume that good will, separate and distinct from tangible property, is property used in the business." 15 F.2d at 633. Of course, it now is a "realit[y] of modern business" that customer-based intangible assets are "bartered and sold as discrete vendible assets." *Houston Chronicle*, 481 F.2d at 1253; see also *Northern Natural Gas Co.*, 277 F.2d at 140 (Blackmun, J., concurring) (tax depreciability should "coincide with good business practice"). Whatever the derivation of the phrase, settled principles make it clear that an intangible asset that has a determinable limited useful life and reasonably ascertainable value is "separate and distinct from goodwill" for purposes of depreciation.

C.B. 65, 66 (emphasis added). See also Rev. Rul. 76-520, 1976-2 C.B. 42 (adhering to factual test of Revenue Ruling 74-456 in specific context of depreciability of subscription-based intangible).

Notwithstanding its litigation position, IRS officials continue to recognize the controlling applicability of the "facts and circumstances" test to determine whether an intangible asset has a determinable limited useful life and therefore is depreciable. For example, in testimony to Congress in October 1991, the IRS Chief Counsel acknowledged that Revenue Ruling 74-456 remains the Service's latest official promulgation on this issue and that, under its standard, "there are facts that would be relevant to" depreciation of an asset "separate and distinct from goodwill. * * * [The law] put[s] taxpayers to the test of trying to prove [such depreciation]." *A Bill to Simplify Tax Treatment of Intangible Assets and Related Legislation: Hearings on H.R. 3035 Before the House Comm. on Ways and Means*, 102d Cong., 1st Sess. 29 (Oct. 2 & 29, 1991) (testimony of IRS Chief Counsel Shashy). The Commissioner of Internal Revenue similarly stated that each case involving depreciation of intangible assets "presents another dispute on the facts" and "requires a particularized effort. * * * [E]ach case must be examined and litigated on a factual basis" and "becomes a challenge to the taxpayer's method of valuation, determination of useful life, and amortization method." *Id.* at 3, 4, 6 (prepared statement of IRS Commissioner Goldberg). And the Assistant Treasury Secretary for Tax Policy, after also noting that "decisions allowing amortization [under existing law] depend[ ] upon the facts of the particular case," specifically recognized that the Third Circuit's decision in this case created "a different world than the world that we're in." *Id.* at 13, 56-57 (testimony of Assistant Treasury Secretary Gideon). See also *id.* at 37 (statement of Rep. Vander Jagt)

(criticizing the "change in position taken by the IRS" that depreciability can be decided as a matter of law).[11]

C. The Judicial Trend Toward Greater Recognition Of The Depreciability Of Intangible Assets Confirms The "Facts And Circumstances" Test And Accords With Sound Tax Policy

Our submission—that an intangible asset is subject to depreciation if the taxpayer demonstrates that, under a "facts and circumstances" test, it has a determinable limited useful life—is confirmed by three-quarters of a century of experience under the depreciation provision of the tax code. This history shows a trend toward the depreciation of an ever-increasing number of intangible assets, which supports the "facts and circumstances" standard but is squarely irreconcilable with the government's assertion that an array of intangibles are nondepreciable as a matter of law.

The statutory provision for depreciation has not been changed in any relevant respect for some 75 years. See page 8, *supra*. Likewise, the IRS's regulation has remained substantially the same since 1927. See pages 11-12, *supra*. And the case law evidences no string of overruled decisions or other doctrinal reformation.

Notwithstanding this stability in the sources of governing law, it is quite clear that a variety of intangible assets

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[11] Because the IRS's argument rests on an unexplained change in its legal position (see also pages 9-13, *supra*), it is not entitled to deference from this Court. See, *e.g.*, *Fribourg Navigation Co.*, 383 U.S. at 279-280 ("[t]he Commissioner's position represents a sudden and unwarranted volte-face from a consistent administrative and judicial practice"); *Transco Exploration Co.* v. *Commissioner*, 949 F.2d 837, 840 (5th Cir. 1992) (the Commissioner "ought to do more than stride to the dais and simply argue in the opposite direction"); *Woods Investment Co.* v. *Commissioner*, 85 T.C. 274, 281-282 (1985); see also *Central Illinois Public Serv. Co.* v. *United States*, 435 U.S. 21, 31, 32 (1978) (rejecting IRS's argument that was inconsistent with regulations).

once held to be nondepreciable may be depreciated today. For instance, depreciation of customer structures and lists (like the asset involved in this case) at one time was disallowed but subsequently was permitted and has been regularly upheld since *Houston Chronicle*. See 481 F.2d at 1251; see also, *e.g.*, *Donrey*, 809 F.2d at 537; *Computing & Software, Inc.* v. *Commissioner*, 64 T.C. 223 (1975), acq., 1976-2 C.B. 1. Likewise, insurance expiry lists now are held to be depreciable even though such claims previously were disallowed. See *Richard S. Miller & Sons*, 537 F.2d at 451 & n.14.

The government's argument fails to account for this trend of decisions. Because the applicable statute and regulation have remained unchanged, the allowance of a deduction for an asset whose depreciation previously had been disallowed would be inexplicable if the government were correct that the depreciability of these assets is determinable as a matter of law. The consistent course of decisions over the past generation is a telling refutation of the government's basic argument.[12]

By contrast, the "facts and circumstances" test provides a ready explanation for this trend. That a decision (especially an older decision) denied a depreciation deduction for a type of intangible asset on the particular trial record presents no inconsistency with another (and much

[12] Even the older decisions disallowing the deduction analyzed the claimed depreciation as a matter of fact rather than as a matter of law. Surveying these cases, the court in *Houston Chronicle* explained that they "turn on * * * factual question[s] and thus stand not so much for the proposition that the type of asset is never amortizable as they do for the conclusion that the very asset involved failed to qualify for one or more particular reasons. * * * [M]ost of the cases denying § 167(a) deductions to intangibles clearly rest on a failure of the taxpayer to carry his burden of proof." 481 F.2d at 1245, 1246. This mode of analysis of the older opinions, even when ruling in favor of the government, is incompatible with the government's current argument that the depreciability of these assets is a question of law, not of fact.

later) decision allowing a deduction for the same type of asset on a completely different record. More to the point, appraisal methodologies have progressed over time based on greater experience, improved computer technologies, and better statistical analyses and economic models. In light of these advances, a limited useful life and reasonable value now can be determined for many assets that previously could not be lifed and valued. As the Tax Section of the New York State Bar Association recently explained, "the development of more sophisticated valuation techniques" has led to an "expansion in the number of intangibles taxpayers are able to amortize," and "[s]ince *Houston Chronicle* * * * the outcome of most cases on amortization of customer-based intangibles has rested to a large degree on the sophistication of the taxpayer's proof." *Report on Proposed Legislation on Amortization of Intangibles (H.R. 3035)*, 53 TAX NOTES 943, 946 (1991). Other commentators similarly have explained that, because goodwill consists of "all intangible commercial advantages which have not been specifically identified, valued and analyzed as to their useful lives," taxpayers "have been able to peel away at the sphere [of goodwill] by utilizing sophisticated and objective methods * * * to identify more and more of the intangible advantages [reflected in the purchase price of a business]." Gregorcich, 28 TAX LAWYER at 270. This evolution is limited not by a *per se* rule that renders certain intangible assets nondepreciable as a matter of law, as the government urges, but rather by the taxpayer's burden to prove "value and determinable life" on the basis of the relevant facts and circumstances. *Ibid.*

What is more, this trend toward depreciability of a wider range of intangible assets is supported by sound tax policy. As discussed above (see pages 6-8, *supra*), the federal income tax is intended to be imposed on net income, and this objective is best served by an accurate determination of deductions that matches expenses and income for each tax year. Disallowance of depreciation for wasting

intangible assets runs counter to that principle for, as the GAO recently explained, it

> fails to recognize the economic benefits that wasting intangible assets contribute over time. * * * Denying amortization deductions does not result in an accurate determination of taxable income since expenses are not properly matched to income generated.

GAO Report at 5. Thus, "*[d]isallowing amortization of any wasting purchased intangible asset would not result in the proper matching of business expense and revenue.*" *Id.* at 37 (emphasis added).

Similarly, generally accepted accounting principles, both in this country and internationally, recognize the need to depreciate intangible assets to provide an accurate determination of income. See, *e.g.*, GAO Report at 11-12, 34-35; *1991 Hearings* at 12 (prepared statement of Assistant Treasury Secretary Gideon), 11-13 (testimony of Assistant Treasury Secretary Gideon). Whatever differences may exist in other respects between tax and financial accounting, here "they coincide in their overall objective to accurately measure income. * * * Although each system may use different technical rules to achieve their basic objectives, the accurate measurement of income is fundamental to both of these systems." GAO Report at 12.[13] Allowing depreciation for intangible assets that have a determinable limited useful life thus "is in accord with sound principles of accounting" (*Niagara Falls Brewing Co.*, 282 U.S. at 654) and satisfies the "primary concern" that depreciation be treated "in a manner that comports with accounting and taxation realities." *Idaho Power Co.*, 418 U.S. at 10. See also *Northern Natural Gas Co.*, 277 F.2d at 140

[13] Indeed, modern accounting principles treat goodwill itself as a depreciable asset. While, in light of IRS regulation 1.167(a)-3, the tax law does not go that far, generally accepted accounting principles support depreciability of intangible assets that have a determinable limited useful life.

(Blackmun, J., concurring) (tax depreciation should "coincide with * * * good accounting"). While financial accounting is not controlling on tax issues, it is at least relevant (see *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 540 (1979) ("in most cases, generally accepted accounting practices will pass muster for tax purposes")) and, on the present question, confirms the depreciability of petitioner's customer-based intangible.

D. The Government's Proposed Denial Of Depreciability As A Matter Of Law Is Unsound In Principle And Unworkable In Practice

The government's argument hinges on its definition of goodwill as the expectancy that existing customers will continue to patronize the business in the future. Significantly, that definition nowhere appears in the tax code or IRS regulation. On the contrary, under the statute (which does not even mention goodwill) and regulation (which does not define goodwill), the distinction between depreciable intangible assets and nondepreciable goodwill is determinable limited useful life. See pages 8-13, *supra*.

Furthermore, the definition proffered by the government is simply one of several different meanings given to goodwill. The term has "a varying content" and has been variously described, for example, as an intangible asset that "has no ascertainable useful life," "the aggregate of all of the intangibles of a business," "the return on all the intangibles of a business," "a rate of return on investment which is above normal returns in the industry," and "the expectancy that the old customers will resort to the old place * * * [for any of] the imponderable qualities that attract customers." *Richard S. Miller & Sons*, 537 F.2d at 450-451. Even the Third Circuit acknowledged that goodwill is an "elusive concept" and that there is no "uniform," "coherent," or "clear" definition of the term. Pet. App. 10a n.5. In fact, two or more for-

mulations often appear side-by-side in opinions—as they did in the district court's opinion in favor of petitioner in this case (*id.* at 45a). See, *e.g.*, *IT&S*, 97 T.C. at 507 n.11; *Citizens & Southern*, 91 T.C. at 480-481; *Computing & Software*, 64 T.C. at 232-233. The government has advanced no ground—other than its desire to prevail in this litigation—for what is its essentially arbitrary and unsubstantiated choice among these meanings.[14]

Worse yet for the government, its concept of goodwill does not provide a definition that has a determinate content and is capable of rigorous and consistent application. Goodwill is a highly abstract and amorphous idea that first developed precisely because of the inability to identify specifically all of the constituent elements of the value of a business. To make the idea more intelligible, it was sometimes discussed in terms of a familiar and observable consequence: the continued patronage of customers. But that formulation is simply an intuitively understandable *description*, not a *definition* or standard that can practicably be applied to guide administration of the tax laws and

[14] Moreover, it is not unanimously agreed that continued customer patronage by itself amounts to goodwill:

> [T]he phenomenon of customer loyalty, or habitual return, unaccompanied by some measure of economic success or potential for excess earnings, does not indicate the presence of goodwill. * * * It is only when public confidence, financial and commercial credit, and the other elements of competitive advantage produce earnings, or their potential, in excess of normal returns that the element of goodwill can be isolated.

Note, 81 HARV. L. REV. at 860. In fact, contrary to the government's position, courts have recognized that an operating business with continued customer patronage may have no goodwill in some circumstances. See, *e.g.*, *Montgomery Coca-Cola Bottling Co.* v. *United States*, 615 F.2d 1318, 1322 (Ct. Cl. 1980) (no goodwill in business operated pursuant to a franchise); *Zorniger* v. *Commissioner*, 62 T.C. 435, 444-445 (1974) (same); *Pensacola Greyhound Racing, Inc.* v. *Commissioner*, 32 T.C.M. (CCH) 1064, 1069 (1973) (no goodwill in monopoly or quasi-monopoly market).

resolve contested cases; it does "no more than to describe the elephant by talking about the place in which the elephant lives." Gregorcich, 28 TAX LAWYER at 274. Because it lacks analytical content, the government's approach to the depreciability of intangibles is a prescription for confusion and continuing disputes in this important area of the tax code. Indeed, its position exacerbates what the IRS Commissioner aptly characterized as "the oppressing burden of seeking answers to metaphysical questions." *1991 Hearings* at 9 (prepared statement of IRS Commissioner Goldberg).

In addition to this unworkable uncertainty, the government's approach is conceptually flawed. The government assumes that some intangible assets are "quintessentially goodwill" or "the very essence of * * * goodwill" (Pet. App. 3a, 7a) and that such assets are nondepreciable even though "they have wasting lives * * * and ascertainable values." *Id.* at 29a. Courts have soundly rejected, however, this sophistical search for the true and inherent character of an asset. As the Tax Court has explained, courts should not "inquire into the intrinsic nature" of an asset to "determine whether it is, in essence, goodwill. * * * [W]here the useful life of an intangible is shown to be limited, depreciation is available even though for some purposes it is an element of goodwill." *Colorado National Bankshares*, 60 T.C.M. (CCH) at 789, 790; see also *Richard S. Miller & Sons*, 537 F.2d at 450; *Citizens & Southern*, 91 T.C. at 515 (Cohen, J., concurring) (intangible assets are depreciable even if "part of their value is related to continued patronage of customers of an ongoing business"). It is therefore well settled that an intangible asset is depreciable notwithstanding that it contributes to continued customer patronage and thus in some sense is part of goodwill, and "*any* portion of the purchase price may be amortized" if limited useful life

and ascertainable value can be established. Gregorcich, 28 TAX LAWYER at 270.[15]

Because of this conceptual flaw, the government's argument would incorrectly lead to the disallowance of depreciation for intangible assets that unquestionably are depreciable. For example, a patent may produce a desirable product or enhance a firm's general commercial reputation and thereby induce existing customers to continue to trade; under the government's definition, the patent would be part of goodwill and could not be depreciated. Nonetheless, the IRS's own regulation expressly states that patents are depreciable—and they are depreciable precisely because they are "of use in the business * * * for only a limited period * * * [whose length] can be estimated with reasonable accuracy." 26 C.F.R. § 1.167(a)-3. See also *Richard S. Miller & Sons*, 537 F.2d at 450. A "test" that leads to such untenable results as the government's is analytically incoherent and cannot be accepted.

II. THE REASONABLY ASCERTAINABLE VALUE OF AN INTANGIBLE ASSET IS A QUESTION OF FACT BASED ON ALL THE RELEVANT CIRCUMSTANCES

Like the issue of determinable limited useful life, the issue of reasonably ascertainable value of an intangible asset presents a question of fact for the trier to decide

[15] The government's position also flies in the face of the recent statutory provision and regulations that recognize that goodwill is not amenable to specific identification and valuation but rather merely represents the residual value of an ongoing business over and above the fair market value of all identifiable assets (both tangible and intangible). See 26 U.S.C. §§ 338(b)(5), 1060; 26 C.F.R. §§ 1.338(b)-2T(b)(2), 1.1060-1T(d). The statutory requirement that this residual valuation method be used codifies the Service's longstanding preference for this method of valuing goodwill. See S. Rep. No. 313, 99th Cong., 2d Sess. 252 (1986); see also Rev. Rul. 68-609, 1968-2 C.B. 327. Under the residual method, petitioner's "paid subscribers" would be separately valued and would *not* be included in goodwill.

based on the particular circumstances involved. The cases uniformly have treated the valuation issue as one of fact, and the government does not appear to challenge the valuation of petitioner's "paid subscribers" apart from its argument that such an asset is not depreciable at all. Under the analysis established in Section I, *supra*, the specific valuation methodology used has no bearing on whether the asset is depreciable *vel non*; once an asset has been determined to have a limited useful life, the validity of the valuation method is a separate issue. Accordingly, the government's effort to determine nondepreciable goodwill based on the particular valuation methodology used is misguided.

A number of valuation methodologies exist for intangible assets. As the district court stated, and as occurred in this case, "[t]he income approach is commonly used to value intangible assets of a going business, other than goodwill and going concern value." Pet. App. 43a. In brief, the income method determines the present value of the net income stream the asset is expected to produce over its useful life. See, *e.g.*, *Citizens & Southern*, 91 T.C. at 480, 498. "[T]he income approach is, in fact, what buyers and sellers would utilize to determine the price at which these assets would change hands" and "best reflects" an asset's fair market value. Pet. App. 43a. The government's approach would essentially preclude application of the frequently used income method in valuing intangible assets because, in its view, valuation based on future income *per se* would establish that an intangible is part of nondepreciable goodwill.

Under the correct analysis, the ultimate question for the trier is whether the taxpayer's valuation is reasonable in light of the facts and circumstances presented. See 26 U.S.C. § 167(a); page 17 & note 9, *supra*. Here, the district court, following a four-day bench trial, accepted "both the methodology and valuations submitted by [peti-

tioner's] experts." Pet. App. 45a. In an extensive opinion, the court carefully justified the income-method valuation used in this case. At the same time, it explained in detail the multiple defects in the government's cost method of valuation and the government's failure (indeed, refusal) to introduce any proof at trial to contest petitioner's application of the income method. *Id.* at 42a-47a. Significantly, although the court of appeals suggested that it might well have come to a different result if it had been the trier (*id.* at 29a-30a), it did not overturn a single one of the district court's valuation findings as clearly erroneous. Given the district court's undisturbed findings, any possible valuation issue was at an end.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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IN THE

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OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

---

BRIEF OF PHILIP MORRIS COMPANIES INC. AS *AMICUS CURIAE* IN SUPPORT OF NEITHER PARTY

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BRIEF OF PHILIP MORRIS COMPANIES INC. AS *AMICUS CURIAE* IN SUPPORT OF NEITHER PARTY

INTEREST OF AMICUS CURIAE

A wholly-owned subsidiary of *amicus curiae* is appellee in a case currently pending before the United States Court of Appeals for the Second Circuit, *Philip Morris Incorporated* v. *Commissioner of Internal Revenue*, Second Circuit No. 92-4025, *on appeal from* 96 T.C. 606 (1991). The issue in *Philip Morris* is the correctness of findings of the United States Tax Court regarding valuation of the "goodwill" of The

Seven-Up Company at the time of its acquisition through an unsolicited public tender offer.

The parties in the instant case have stipulated to the value of the "goodwill" of the acquired newspapers. They thus have eliminated from consideration by this Court the issue presented in *Philip Morris*. Nevertheless, because of certain statements of the parties here, *amicus* is concerned that the issue of proper goodwill valuation may somehow be woven into the resolution of the instant case, thereby inadvertently affecting its pending case.

The written consents of the parties have been filed with the Clerk of this Court pursuant to Rule 37.

ARGUMENT

The instant case presents the question whether a particular intangible asset—referred to as the "paid subscribers" of an ongoing newspaper business—is a proper subject for depreciation under 26 U.S.C. § 167(a) or, rather, is a part of nondepreciable "goodwill."

The instant case does *not* present an issue as to the proper method of valuing the "goodwill" of the acquired newspapers. That is because the parties have stipulated that the method to be used to value that intangible asset is the so-called "residual method."[1] Pursuant to the stipulations of the parties, the value of the goodwill of the acquired newspapers will be

[1] In general, under the residual method, the price paid for a business is assumed to equal the value of the business's assets, the value of all assets other than goodwill is subtracted from the total price paid, and the residual amount is treated as the value of the goodwill.

the difference between a specified amount ($89,578,685) and the ascertained value of the paid subscribers if found to be depreciable. (Pet. App. 37a.) There will thus be no occasion for this Court to consider the propriety of the goodwill valuation.

Nevertheless, in its Brief on Petition for a Writ of Certiorari, the United States made two assertions that at least suggest the possibility that the proper method of valuing goodwill might somehow get placed before this Court in the instant case. Specifically, the United States stated that, in petitioner's allocation of purchase price among the acquired assets, goodwill was "required" to be assigned the remainder of the purchase price after all other assets (tangible and intangible) had been valued. (Brief for the United States on Petition for a Writ of Certiorari ("Cert. Br. U.S.") 2-3.) The United States also claimed that any "premium" paid for a business over and above what the tangible assets would be worth if bought individually is "associated with the going concern value or goodwill of the business." (Cert. Br. U.S. 15.) In addition, in its brief on the merits, petitioner uses the term "residual" in describing how goodwill should be defined and valued for purposes of Section 167. (*See, e.g.*, Brief of Petitioner Newark Morning Ledger Co. 3, 19, 37.)

As is clear from the relevant authorities, any suggestion that the residual method is the only appropriate way to value goodwill in all circumstances is incorrect. The law in effect when the acquisition here involved took place did not mandate use of the residual method to value goodwill. (*See, e.g., R.M. Smith, Inc.* v. *Commissioner*, 591 F.2d 248 (3rd Cir.), *cert. denied*, 444 U.S. 828 (1979); S. Rep. No. 313, 99th

Cong., 2d Sess. 252-253 (1986); *see also* Treas. Reg. Sec. 1.334-1(c)(4)(viii).) The parties here merely agreed to use that method.

Further, the Third Circuit in *R.M. Smith, supra,* has made it clear that a "premium" paid for the stock of a corporation, over and above the value of its tangible assets, would not inevitably represent the value of its goodwill and that the residual value method may be inapplicable "when one party to the transaction achieves a bargain." 591 F.2d at 252-253.

The issue in the pending *Philip Morris* case is the propriety of the Tax Court's conclusion that it was appropriate to value goodwill using the so-called "excess earnings" method based upon Rev. Rul. 68-609, 1968-2 C.B. 327, rather than the residual method.[2] *Philip Morris* involved an acquisition by unsolicited public tender offer where the total purchase price was found to include a "control premium" and the requisite equivalence called for in *R.M. Smith* between the price paid and the value of the assets was found not to be present.

Amicus thus wishes to make it clear that (a) the courts have rejected any suggestion that the residual method invariably was required for valuing the goodwill of a going business during the period here involved, and (b) in any event, the question of how to value goodwill is not now before this Court.

---

[2] In general, under the "excess earnings" method, goodwill is valued by reference to the earnings deemed attributable to those intangible assets not separately valued.

CONCLUSION

For all of the foregoing reasons, *amicus* respectfully requests that this Court avoid possible confusion in this area by expressly indicating in its opinion that the proper method for valuing the goodwill of a going business is not at issue in the instant case.

Respectfully submitted,

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BRIEF OF AMICI CURIAE THE NEW ENGLAND FUEL INSTITUTE, THE EMPIRE STATE PETROLEUM ASSOCIATION, THE FUEL MERCHANTS ASSOCIATION OF NEW JERSEY, AND THE OREGON PETROLEUM MARKETERS ASSOCIATION IN SUPPORT OF PETITIONER

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INTEREST OF THE AMICI CURIAE

The New England Fuel Institute ("NEFI"), the Empire State Petroleum Association ("ESPA"), the Fuel Merchants Association of New Jersey ("FMA"), and the Oregon Petroleum Marketers Association represent more than 2500 companies that comprise about 75 percent of the United States retail heating oil

industry. Virtually all of these companies are privately held and independent of any oil producer or refiner. Most are family owned, many in their second or third generation of family management. They primarily market heating oil to residential and commercial end users.

The retail heating oil industry is highly fragmented. Many small companies were established in the 1940's and 1950's by sole proprietors who are now reaching retirement age. As a result, there is considerable consolidation in the industry. These companies' assets are largely intangible, the most valuable of which are indefinite term contracts with existing customers to sell heating oil pursuant to "automatic delivery" arrangements. In recent years, hundreds of heating oil companies have been valued and purchased in reliance upon decided cases allowing amortization of these contractual customer relationships over their useful lives.[1] The government acquiesced in this practice in all of the audited transactions of which we are aware.

Pursuant to an automatic delivery contractual relationship, oil is delivered, based on historic consumption patterns and weather conditions, until the customer exercises a "negative option" to terminate. Based on historical use patterns, each customer's anticipated purchases can be calculated with considerable accuracy and certainty,[2] as can the anticipated

[1] *See Holden Fuel Oil Co. v. Commissioner*, 479 F.2d 613 (6th Cir. 1973); *ABCO Oil Corp. v. Commissioner*, 90 T.C.M. ¶ 90,040 (1990).

[2] A full-service heating oil dealer may also have a number of non-contractual or "will call" customers. Their gallonage is less predictable and is not included in the calculation of value related to the customer base.

decline in the number of customer relationships. Typically, the useful life of a customer base is seven to ten years.

Acquisitions in the heating oil industry always include the transfer of the seller's principal asset—the right to deliver heating oil to existing customers until the contracts are cancelled. The purchase of customer relationships may be with or without a transfer of name, employees or management. The purchaser ordinarily obtains not only names, addresses, and information concerning the customers' heating systems and fuel use patterns, but also the assignment of the contractual right to deliver oil until the agreement is terminated. More than 75 percent of the value of a fuel oil business is its customer relationships, sold with or without the company name and management.

A retail heating oil dealer has virtually no "goodwill" as understood in the lay sense. There are no product brand names. Competing dealers sell the identical product.[3] Sales are not made from any retail sales outlet. Thus, there are no preferred brand names or locations, as there are in most retail sectors; and sales are made either at the customer's home or by telephone. There are extremely low barriers to entry, the requirements being only a fuel oil delivery truck and enough working capital or credit to acquire inventory. There are hundreds of competitors in many markets.

For two decades and in scores of transactions, the IRS has approved the amortization of the value of an acquired heating oil customer base separately from

[3] Heating oil is not generally sold using the brand name of a major oil company supplier.

"goodwill." Where substantially all of the assets of a seller are transferred, the IRS has insisted that a portion of the purchase price be allocated to goodwill (usually from 5 to 25 percent of the total intangibles), but has concurrently approved deductions to amortize a separate, wasting customer base as described above.[4] This IRS practice has been relied on in numerous transactions and in financings therefor.

The amici curiae are concerned that the *per se* rule of law announced by the Third Circuit could be applied to the heating oil industry, with unjustified, inequitable and serious adverse economic impact on the small businesses comprising the industry. It would remove the financial underpinnings of prior transactions in which customer relationships are currently being amortized, even though prior deductions related to these very transactions have been approved in prior audits. In short, it would substantially reduce the value of these businesses and undermine their financial integrity.

SUMMARY OF ARGUMENT

The court of appeals' *per se* test, denying amortization of all customer-based intangibles when purchased with a going concern, directly conflicts with Internal Revenue Code Section 167(a) and grossly distorts the intent of the regulations issued thereunder, which both require a depreciation allowance for wasting assets. The court of appeals would have a trier

[4] The IRS challenged the deductions taken by one heating oil dealer, but did not appeal its loss in the Tax Court, which held that the customer relationships had limited useful lives, had a value separate from goodwill and thus were depreciable. *ABCO Oil, supra* note 1, at 193-94.

of fact ignore, contrary to the Code, evidence that acquired customer relationships have ascertainable, declining value, on the basis that the taxpayer had not met the additional requirement that it prove the asset has no attribute of "goodwill," as used in the lay sense. Such a test would impose an amorphous standard not contemplated by the Code, producing inappropriate results and upsetting the basis of numerous completed and proposed transactions.

The proposed rule—prohibiting amortization of wasting customer relationships if sold together with any element of "goodwill"—produces incongruous results. A wasting asset that can be sold or reproduced separately, and hence which is deductible, would lose its separate value and deductibility when it is sold as part of a going concern. According to the court of appeals, any asset, even those that are plainly amortizable, if interrelated with goodwill would become non-amortizable. A patent or copyright, for example, that is intermingled with "goodwill" would not be amortizable, in conflict with IRS rules regarding their amortization. A separately valued customer relationship is no different from a patent or copyright in this regard. Some factual circumstances may, by their nature, increase the taxpayer's evidentiary responsibilities to prove the separate value of customer relations, but if a value for this wasting asset is demonstrated, a deduction must be allowed.

Further, the Government's attempt to distinguish between fixed-term and terminable contracts conflicts with the Service's own regulations, which permit "experience or other factors," 26 C.F.R. §1.167(a)-3, to guide a determination of useful life, and which specifically reject utilizing the "useful life inherent in the

asset" in favor of "the period over which the asset may reasonably be expected to be useful . . . ." 26 C.F.R. §1.167(a)-1(b). The distinction ignores the real-world value placed by purchasers on other contractual relationships, based on business experience.

The experience of the heating oil industry illustrates the unreasonableness of the Third Circuit's *per se* rule and its incompatibility with market reality. Like newspaper subscribers, heating oil customers have requirements contracts without explicitly fixed duration (although the "negative option" may be more specific). Also like newspaper subscribers, heating oil customers move, die, change suppliers over periods that can be ascertained and established, with even greater certainty than many tangible assets. Distinctively, however, heating oil customer relationships are sold regularly in every major market, with and without the name, management, or employees of the seller. Also unlike newspapers, heating oil companies have virtually no "goodwill" as commonly understood. Heating oil is a commodity, and thus the product is brandless and fungible, and the principal distinguishing factor is price, which means that the name and reputation of a heating oil company does not have substantial value. Yet, despite this lack of traditional "goodwill," the Third Circuit's rule would anomalously define most of a heating oil company's asset base as goodwill.

Further, the heating oil industry offers everyday examples of customer relationships that are valued by several methods—income, comparable sales, and replacement cost—in transactions that involve little or no "goodwill." This practice of valuing customer relationships separately from "goodwill" has been accepted by the IRS, and is in direct conflict with the new *per se* rule announced by the court of appeals.

The prevailing fact-based standard for determining whether an asset has a limited useful life and a separate value is the only test that can address the wide variety of assets and industries in which this subject arises. If a simpler rule is sought, Congress must modify this provision of the Code, which has been left unchanged for 75 years.

ARGUMENT

I. THERE IS NO LEGAL BASIS ON WHICH TO DENY A DEPRECIATION DEDUCTION FOR INTANGIBLE ASSETS THAT WASTE

A. The Internal Revenue Code Provides a Single Requirement for the Depreciation of an Identifiable Intangible Asset—That It Have a Wasting Life—Which Was Satisfied Here

Under Section 167(a) of the Code, all that is required to sustain a deduction is that an identifiable business asset have a measurable and ascertainable useful life, *viz*: "There *shall* be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear . . . " of property used in a trade or business. 26 U.S.C. § 167(a) (1988) (emphasis added).

Applying the statute, the district court made two critical factual findings: first, that Morning Ledger's customer relationships wasted due to "death, relocation, lack of reader time or interest, changing lifestyles . . . dissatisfaction with the product or service and for various other reasons, including competition from other media sources, such as radio, television, magazines and other . . . newspapers" (Pet. App. 40a);

and second, that the relationships "were not self-regenerating, i.e., there is no automatic replacement for a subscriber who terminates his or her subscription." *Id.* The Government "did not contest" critical evidence; indeed it "stipulated to Morning Ledger's estimates of the useful lives of the subscription relationships." Pet. App. 6a.

On appeal, the Third Circuit acknowledged that a determination as to useful life is "generally a factual question" (Pet. App. 8a), and it did not disturb the district judge's factual findings as to useful life. *Id.* at 29a.[5] Instead, it asserted that "notwithstanding" that the customer relationships "have wasting lives," they are "nonetheless goodwill and nondepreciable." (Pet. App. 29a).

This conclusion is irreconcilable with Section 167(a), because identifiable assets that waste over a limited period are *per se* depreciable; and characterizing them as "goodwill," which does not have an ascertainable limited life, is not merely contradictory, but irrelevant. The court made no attempt to reconcile its holding with Section 167(a). On this facial conflict alone, the decision below should be reversed.

B. The Test Adopted by the Third Circuit Conflicts with the Statute and the Regulation, Creates Confusion in the Law, and Should be Rejected

The Third Circuit's holding also conflicts with the IRS interpretive regulation, which properly provides that wasting intangibles are depreciable. The regulation allows depreciation for any "intangible asset

[5] The only factual finding overturned related to whether the subscriber list was "separate and distinct from goodwill." Pet. App. 30a.

. . . of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy . . . ." 26 C.F.R. § 1.167(a)-3 (1990). Patents and copyrights are specific examples. *Id.* Conversely, "[a]n intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation." *Id.* "Goodwill" is set forth expressly as an example of an asset for which "[n]o deduction for depreciation is allowable." *Id.*

The IRS described its "controlling rule," in Regulations adopted initially in 1918, as follows: "Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance." T.B.R. 44, 1 C.B. 133, 134-35 (1919). The corollary, that goodwill is nondepreciable, follows because "goodwill has an indeterminate useful life." Brief of the United States at 28, No. 90-5637 (3d Cir.). The essence of this distinction is established by a facts-and-circumstances analysis of whether an identifiable asset has a limited useful life. This rule has not changed in almost 75 years.

The Third Circuit's application of the IRS regulation is demonstrably erroneous because it ignores the very criterion established by the Code—whether the asset exhausts—and thus the court ignored evidence showing the *limited duration* of purchased customer relationships due to their predictable and measurable *exhaustion*. The court found, in direct conflict with the statute,[6] that "there are some intangible assets

[6] The IRS's regulation is consistent with the statute to the extent that its characterization of "goodwill" as nondepreciable is read as an example of a nonwasting asset. To the extent it

which, *notwithstanding that they have wasting lives* that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." App. 29a (emphasis added).

The Third Circuit based this holding on a definition of "goodwill" (the "expectation of continued patronage") not present in the Code or the regulations and that is, at best, one definition among many.[7] Even if defining goodwill were relevant to the determination of deductibility, there is no evidence that Congress envisioned any such definition when it enacted Section 167 or any related law.[8] Further, the IRS has not so

sets up "goodwill" as an independent concept that embraces wasting assets, it is in conflict with the Code. To the extent there is ambiguity, the IRS regulation should be construed to harmonize with the language of the governing statute. *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 477 (1979).

[7] Goodwill has been defined in various ways. As characterized by the court of appeals, it is the expectancy that the old customers will resort to the old place. Pet. App. 10a-11a. In economic terms, goodwill may be viewed as the excess over the rate of return on tangibles and intangibles customary in an industry, Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 Harv. L. Rev. 859, 861 (1968), but it has also been defined as the normal rate of return on intangibles only. *Richard S. Miller & Sons Inc. v. United States*, 537 F.2d 446, 451 (Ct. Cl. 1976). In accounting terms, goodwill is an intangible asset comprising "the cost of an acquired enterprise over the sum of identifiable net assets." ASCT §§ 160.101, 160.401; APB Op. No. 17 ¶ 1.

[8] The only definition of "goodwill" adopted by the Congress is a "residual" one—*i.e.*, the value that remains after all separately identifiable tangible and intangible assets are valued. In an asset acquisition, if the purchaser and seller agree in writing as to the allocation of consideration, they must use the residual method for valuation of goodwill. 26 U.S.C. § 1060(a) (1991); 26 C.F.R. § 1.10601T-(a)(1),(d)(iii) (1990); 26 U.S.C. § 338 (1988); 26 C.F.R. § 1.338(b)-2T(d)(xiii) (1988). The residual method was employed by Morning Ledger. Pet. App. 37a.

defined goodwill in its regulations. Pet. App. 10a n.5. Finally, the definition does not even comport with standard usage, *see Webster's Third New International Dictionary* at 979 (1976), or with economic principles or accounting practices.[9]

In fact, no independent definition of "goodwill" is necessary to apply this regulation because goodwill for this purpose must be, under the Code, those assets which have no ascertainable limited useful life. The purchased subscriber base here clearly is not "goodwill" because it is not self-regenerative (Pet. App. 40a-41a) and has a limited and ascertainable useful life. (Pet. App. 40a).[10] The customer relationships are distinct assets of the seller, and were valued as such by the purchaser, and these relationships will exhaust themselves over a reasonably predictably period, just as will trucks or other tangible assets purchased. The

[9] *See, supra*, n.7.

[10] The assumption that goodwill has an unlimited life has been questioned. Even after *Clarke v. Haberle Crystal Springs Brewing Co.*, 280 U.S. 384 (1930), Judge Hand adhered to the view that goodwill is depreciable. *Williams v. McGowan*, 152 F.2d 570, 572 (2d Cir. 1945). *See also* Gregorich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 Tax Lawyer 251, 274 (1975); Note, *supra* note 7, 81 Harv. L. Rev. at 863. The notion is that the "excess profits" produced by goodwill *will* waste unless management continually invests in product quality, customer service, and other profit-producing areas. For example, it is apparent that the "goodwill" of certain domestic automobile manufacturers has wasted to some degree over the past twenty years, although possibly in an unpredictable manner.

district court so found, and the court of appeals did not disturb that determination.

C. Examples Illustrate How Wasting Customer Relationships Have A Value Distinct From "Goodwill"

The Third Circuit's decision rests principally on its view that when a customer base is "acquired in conjunction with the sale of the underlying business as a going concern . . . it is simply often too difficult . . . to separate the value of the list *qua* list from the goodwill value of the customer relationships/structure." Pet. App. 29a. However, wasting customer relationships and goodwill are regularly identified and valued separately by prospective purchasers. That a transaction may transfer *both* assets at the same time does not mean that the two merge, lose their separate identities, and cannot be valued separately. To the extent these assets are valued separately by purchasers, sellers, bankers,[11] economists and financial appraisers, there is no reason why they cannot be valued separately by the taxpayer and the court. The following examples may serve to illustrate this point:

1. A prospective purchaser (or lender to the purchaser) of the Baltimore Orioles sports franchise would value the income from season ticket holders separately from customers who purchase tickets on isolated occasions. The season ticket holders buy in season "lots," are identified, have a measurable duration of patronage and thereby present relatively predictable patronage and income, the present value of which is ascertainable. Patrons that buy only isolated games are not readily identifiable, and have ticket purchasing habits that are uncertain. Their value or their duration is more speculative. For these reasons, season ticket holder relationships have a separate (and obviously greater) value than those involving per-game sales.

If it were shown that the base of season ticket holders wasted in a readily predictable manner and had an ascertainable value, a deduction would be required under the statute. By contrast, the value of the expected single game purchases would present a very different set of evidentiary hurdles and would likely be accounted for as goodwill. The fact that the two assets are sold together does not mean that the first is not amortizable.

2. Turning to the heating oil industry, assume, for example, that Company A has 200 customers under contract to deliver their heating oil requirements automatically until the customer exercises an option to cancel (a "negative option contract"). Company B also sells heating oil to 200 customers, but only 100 have negative option contracts, while the other 100 are "will call" customers that are served only if they place an order. Company A will command a higher purchase price in the market. Company A's 200 customer relationships have ascertainable value and a determinable useful life (as will the lesser number of negative option contract customers of Company B). Under Section 167(a), depending on the taxpayer's evidence, these customer relationships will be depreciable. By contrast, B's "will call" homeowners are not likely to have a determinable and reasonably ascertainable useful life, and hence are likely to be nondepreciable.

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[11] For example, bankers will accept a lien on a heating oil dealer's customer relationships, but not on its goodwill value.

3. Similarly, newspapers have both paid subscribers and newsstand purchasers. Say, for example, that A has 90 paid subscribers and averages 10 newsstand purchasers. B has only 50 paid subscribers and averages 50 newsstand purchasers. "A" will command a higher price, due to the higher and separate value, certainty and determinability provided by its paid subscribers. While the newsstand purchasers also have value, their level of purchases and useful lives likely are not reasonably determinable, and thus are of lower value and are apt to be nondepreciable. That *both* are transferred in the same transaction does not negate their separate characteristics.

4. Any perceived "difficulty" (Pet. App. 29a) in separating the value of depreciable customer relationships from "goodwill" is not a basis for denying depreciation where the taxpayer has met its burden of proving value and useful life for the identifiable asset. For example, a patent or copyright may be a principal asset of an enterprise, as in the case of a developer of computer software. The patent for a successful computer program may give the company an advantage over its rivals, enhancing its name recognition and reputation (customarily viewed as components of its "goodwill"). However, even though there may be a relationship between the value of the patent and "goodwill," a depreciation allowance is specifically provided for by regulation, 26 C.F.R. § 1.167(a)-3, because a patent has a limited useful life. The commercial value of the patent, established by evidence, lays the basis for a depreciation allowance, which is permitted.

Thus, even where the value of one asset, such as customer contracts, has some relationship to goodwill,

the asset does not, *ipso facto*, become goodwill or lose its establishable value and depreciability. Rather, the interrelationship simply requires that there be a proper valuation of each asset. The need for valuation, while perhaps not simple or exact, cannot, under the statute, be a basis for denying the deduction entirely, so long as it is reasonable. As Judge Learned Hand commented regarding the difficulty in establishing deductible business expenses:

> Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying something was spent. . . . It is not fatal that the result will inevitably be speculative; many important decisions must be such.

Cohan v. Commissioner of Internal Revenue, 39 F.2d 540, 543-44 (2d Cir. 1930). *See also Massey Motors Inc. v. United States*, 364 U.S. 92, 105 (1960) ("there is a risk of error in such projections [of an asset's life and value], but prediction is the very essence of depreciation accounting"). The same difficulty may exist here, and the same result should apply.

D. Whether Customer Relationships Are Sold With Or Without a Going Concern Is Irrelevant

The Third Circuit drew a distinction between the amortizability of a subscriber list acquired *independently* and a subscriber list acquired *with* the purchase of an ongoing concern. Pet. App. 29a. The court reasoned that when a list is acquired independently,

"there [is] no possibility that the value of the list reflected the value of the seller's goodwill." Pet. App. 26a. Even if true, this cannot be the basis for a *per se* rule denying any deduction because of a possibility that the value of the customer relationship bears some relation to the value of the seller's goodwill. This same possibility exists with any other intangible asset that has a relationship to goodwill, such as a patent that was an integral factor developing the goodwill of the seller, but which, as indicated above, is a depreciable asset.

Further, the value of the customer relationships when sold separately do not evaporate when sold as part of a going concern. It simply means that valuing these intangibles may be more complicated, but as long as the burden of doing so is borne by the taxpayer, a deduction is required.

Unlike a newspaper subscription base, the customer relationships of a heating oil company can be and are sold with and without the hard assets of the seller, the name of the seller, its management and its employee base—*i.e.*, the customer base is often sold without any of these elements of the seller's "goodwill." In either case, however, the customer relationships (1) will waste, and (2) will have an ascertainable, measurable value to the purchaser. If the list is sold *with* the going concern, and *if* the concern has substantial goodwill (that exceeds associated costs and liabilities), it is likely the total value will exceed the value of the relationships sold separately, because the goodwill will attract many *new* customers. These are, however, separate from those already acquired and identified. The number, value and life of these new customers is not readily predictable, because they do

not yet exist. They are therefore properly categorized as part of "goodwill" and are nondepreciable. Whatever the additional value of this goodwill, it cannot diminish the value of the existing customer relationships transferred.

E. Any Distinction Between Fixed-Term Contracts and Contracts Terminable-At-Will Is Unsustainable

The rule urged by the Service would create an artificial distinction between fixed-term contracts and contracts that can be terminated at the option of one party. According to the Third Circuit, "the Service does not dispute, that the value of the paid subscribers would not constitute goodwill if Morning Ledger's 'expectation of continued patronage' were contractually-based" because "[i]n such an event, continued patronage would not be a mere 'expectation,' but a contractual right, and hence not goodwill." Pet. App. 11a-12a. This distinction does not reflect the factors that determine useful life or value, as the following examples illustrate.

Take the following three scenarios involving the purchase of a company that makes widgets.

1. In the first scenario, the widget company has 100 fixed-term contracts, with six-year terms, to sell X number of widgets. In this circumstance, it is undisputed that the contracts have an ascertainable value that wastes over a predictable period. An allowance for depreciation of the six-year value of these relationships would be permitted under the Respondent's rationale.

2. In the second scenario, the company has 100 fixed-term contracts with *two*-year terms to sell X number of widgets, but experience has established

that each contract on average will be renewed twice, so that the total expected term of patronage will be *six* years. The purchaser and seller would recognize that the customer relationships have an ascertainable value that wastes—based on experience and other factors—over a six-year period; and the value of the purchase price will take this into account. Under the Service's reasoning, however, the taxpayer could amortize only the value of the asset related to a *two*-year life, and ignore the wasting value of the last four years, even though the *full*, six-year value of the asset would have been reflected in the purchase price.

3. In the third scenario, the company has 100 contracts, terminable at the option of the customer, to provide customers their full requirements of widgets. It can be demonstrated that these contracts will result in the sale of X number of widgets to each customer over a period of *six* years. The purchaser of this company will have included in its purchase price the present value of six years of sales. In this instance, however, the rule suggested by the Service would deny *any* deduction at all, despite the existence of an identifiable wasting asset with an ascertainable value to a purchaser, based on its demonstrable expectations of useful life, that may be identical to the value of the contracts in the first and second scenarios.

Not only is this distinction between fixed-term and terminable contracts incongruent with real world market values, but also it conflicts with the IRS's own regulations. The regulations provide that "useful life" may be established by "experience or other factors." 26 C.F.R. § 1-167(a)-3. The length of a fixed term contract is but *one* "factor" that may be used to

estimate useful life, but it cannot exclude other factors, if there is evidence of others. In many instances the stated term of a contract will not accurately reflect its useful life, or its value to a purchaser, particularly where the contract is renewed in practice. *See, e.g., Business Service Industries, Inc. v. Commissioner*, 55 T.C.M. (P-H) ¶ 86,086 (1986). Experience may also demonstrate that the useful life is less than the asset's inherent period, for example in the common case where a patent is shown to have a useful life less than 17 years.[12] *See, e.g., Sandvik, Inc. v. Commissioner*, 55 T.C.M. (P-H)¶ 86,588 (1986). The IRS regulations make clear that "the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer. . . ." 26 C.F.R. §1-167(a)-1(b). These regulations require that the expectations of the taxpayer be considered in the determination of the useful life of the asset.

If a clear demarcation is desired, it should comport with economic reality, as reflected in Petitioner's distinction between its newsstand customers, who may or may not purchase a newspaper on any given day, and are not part of its contractual customer base, and, on the other hand, its subscribers, who purchase a newspaper daily. The paid subscribers have an ascertainable value and predictable useful lives; the newsstand customers, by contrast, do not. Given the statutory language, different tax treatment is appro-

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[12] Actual experience may also lead to an estimate of useful life that is shorter than a contract's fixed term, if in practice the contract is not generally honored for its full term and if enforcement is impractical.

priate for these two different classes of customer relationships.

The same distinction is reflected in a heating oil dealer's customer base. Its automatic delivery customers have a contract with the seller for full requirements over an estimable period. On the other hand, its customers who simply call for a single delivery of heating oil are not part of the heating oil dealer's contractual customer structure. The former have ascertainable values that are paid for by the purchaser, have predictable lives, and hence their value is depreciable.

II. CUSTOMER BASES IN THE HEATING OIL INDUSTRY ARE SEPARATELY VALUED USING THREE ACCEPTED METHODS

A. There Is No Single Appropriate Method of Valuation

Fair market value of an asset is a question of fact. *See, e.g., Delaware, Lackawanna & W. R.R. v. Pennsylvania*, 198 U.S. 341, 358 (1905); *Western Union Tel. Co. v. Taggart*, 163 U.S. 1, 24 (1896); *885 Investment Co. v. Commissioner*, 95 T.C. 156, 167 (1990). It is the price arrived at between willing parties, neither under a compulsion to buy or sell. *See Elmhurst Cemetery Co. v. Commissioner*, 300 U.S. 37, 39 (1937); 26 C.F.R. § 1.170A-1(c)(2); Rev. Rul. 59-60, 1959-1 C.B. 237. Accordingly, no single method of valuation is regarded as determinative of value in all circumstances, and the manner in which an asset is to be valued is a mixed issue of fact and law, but highly dependent upon the business circumstances, a factual matter.[13] *See Commissioner v. McCann*, 146 F.2d 385,

[13] "[T]he question of what criterion should be employed for determining the 'value' of [assets] is a question of law." *Powers v. Commissioner*, 312 U.S. 259, 260 (1941). But specific factual determination of value, properly made within a given "criterion," are matters for the trier of fact. *Commissioner v. McCann*, 146 F.2d 385, 386 (2d Cir. 1944).

386 (2d Cir. 1944); *see also* S. Rep. No. 313, 99th Cong., 2d Sess. 252 (1986). The capitalization of earnings method, *Palmer v. Connecticut Ry. & Lighting Co.*, 311 U.S. 544 (1941), the reproduction cost method, *Los Angeles Gas & Elec. Corp. v. Railroad Comm'n*, 289 U.S. 287 (1933); and the comparable sales method, *Kimball Laundry Co. v. United States*, 338 U.S. 1 (1949) are all acceptable valuation techniques. *See also, Procacci v. Commissioner*, 94 T.C. 397 (1990); S. Rep. No. 313, 99th Cong. 2d Sess. at 252 (legislative history accompanying enactment of 26 U.S.C. § 1060 describing three accepted methods of valuation).

Thus, the best valuation method for Petitioner's customer relationships was a matter for the district court, and the Third Circuit could not reverse this finding peremptorily merely because it would have preferred a different method to value the asset. *Anderson v. City of Bessemer City*, 470 U.S. 564, 573 (1985). The district court's finding as to valuation was not clearly erroneous (Pet. App. 29a) and, thus, should not have been overturned.

B. An Appraiser Must Value the Correct Asset, Which Was Not Done Here By the IRS

In addition, an asset must be properly identified, taking into account all relevant facts, including the asset's projected use. *See Guggenheim v Rasquin*, 312 U.S. 254, 257 (1941). In those instances where an expert improperly identifies the asset to be valued,

the trier of fact may reject this valuation. *See Anselmo v. Commissioner*, 80 T.C. 872 (1983), *aff'd*, 757 F.2d 1208 (11th Cir. 1985); *Jacobson v. Commissioner*, 58 T.C.M. (P-H) ¶ 89,606 at 3061 (1989).[14]

Here, the IRS acknowledges that the customer list has value, but insists on use of a replacement cost methodology as the only method that excludes any element of customer patronage. However, in rejecting the IRS' valuation, the district court determined that the IRS valued the wrong asset for the wrong use (Pet. App. 43a)—*i.e.*, a mere list of names instead of a set of customer relationships that would produce predictable income.[15] Consequently, the district court properly rejected this valuation, not because the replacement cost method is not a reasonable valuation methodology, but because it was used to value a wrongly defined asset.

C. In the Heating Oil Industry, All Three Methods Are Available to Value the Customer Base Separately

The district court adopted the "income method" of valuing the subscriber relationships because it best reflected the method used by buyers and sellers in the newspaper industry to determine price. The replacement cost approach was rejected because there

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[14] In *Anselmo*, for example, the Tax Court was presented with valuations of donated gems. The taxpayer's valuation was rejected because the taxpayer's expert had chosen the wrong market in which the gems should be valued: the retail market, instead of a wholesale market. The IRS' valuation was rejected because the IRS' expert had assumed improperly that the gems were to be valued on a bulk sale basis, as opposed to an individual sale basis. *Anselmo*, 80 T.C. at 886.

[15] "The cost of obtaining [a list of subscribers] does not equate with their value to the enterprise." Pet. App. 43a.

was insufficient evidence to establish the actual cost of reproducing the contractual relationships similar to those purchased. Pet. App. 42a-43a. A comparable sales approach was rejected because of insufficient sales of comparable properties. Pet. App. 42a.

The latter two alternative methods of valuation, although not available to the Petitioner, are generally applicable to sales of heating oil customer bases. A replacement cost approach can fairly estimate the level of expenditures required to add new automatic delivery customers to an existing heating oil business. (Heating oil dealers regularly engage in marketing activities to attract new contractual customers.)

In addition, the comparable sales method can be used. Because of the abundance of small companies in this industry, there are many sales of customer relationships and comparable values are often available. Moreover, because heating oil customer bases are often sold without the sellers' name, employees and management, the comparable sales method can value the customer base separately, even in a transaction that includes the transfer of the seller's name, by reference to comparable prices in transactions that do not include the seller's name. Consequently, a comparable sales method can also establish the value of the customer base separate from goodwill.

It is not necessary that all three methods be available. Any method that produces a reasonable estimate of fair market value should be acceptable. *See* cases cited *supra* at 20-21. If the income method is the most appropriate, and is used by the parties to establish market price, as it was here, it should be available to the trier of fact.

The experience of the heating oil industry demonstrates that customer relationships have a value separate from any element of goodwill. Any *per se* rule that equates such customer relationships with nonamortizable goodwill would force courts to ignore the statute and evidence that an asset is wasting and has ascertainable value. It would impose a rule of law that this demonstrable value disappears into the "goodwill" of an enterprise. This result is in conflict with market reality and the plain requirements of the Code.

CONCLUSION

The judgment of the court of appeals should be reversed.

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OCTOBER TERM, 1991

NEWARK MORNING LEDGER COMPANY,
as successor to the Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the Third Circuit, in acknowledged conflict with other circuits and the United States Tax Court, was correct that under the Internal Revenue Code an income-producing wasting intangible asset may be nondepreciable "goodwill" as a matter of law.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-1135

NEWARK MORNING LEDGER CO.,
as successor to The Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

BRIEF OF THE AMERICAN BANKERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF THE AMICUS CURIAE

The American Bankers Association ("ABA") hereby respectfully submits this brief as amicus curiae in support of the Petitioner and with the consent of both of the parties. The signed consents of each are filed with this brief.

The ABA is the principal national trade association of the commercial banking industry in the United States. It has members located in each of the fifty states and the District of Columbia and includes banks of all types and sizes—money center, regional, and community banks. ABA members hold approximately ninety percent of the domestic assets of United States banks. The ABA is in a unique position to express the views of financial institutions regarding the issues raised in this case, especially the Solicitor General's invitation to overrule *Citizens and Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd*

per curiam, 900 F.2d 266 (11th Cir. 1990), and other cases holding that core deposit intangible assets were separate and distinct from goodwill.

Checking, savings, and other deposits, referred to collectively in the banking industry as core deposits, are banks' lowest cost source of funds. Although core deposits are a stable source of funds, they do not remain with a bank indefinitely but close at predictable rates as depositors marry, die, move, or close their accounts for other reasons.

The level of core deposits is an important factor in determining the purchase price of a bank. All other factors being equal, a purchaser is willing to pay more for a bank that has a higher level of core deposits because those deposits can be used to fund loans and other investments at a lower cost than alternative sources of funds. Indeed, it is often the acquisition of the core deposits that represents the economic purpose behind the purchase of a bank.

The core deposit intangible asset, or deposit base, is the intangible asset recorded in a purchase transaction representing the value of the acquired core deposits. Because the core deposit intangible is a wasting asset with a determinable useful life, banks are required by generally accepted accounting principles, by the bank regulatory agencies (the OCC, the FDIC, and the Federal Reserve), and by the SEC, to record the core deposit intangible as an asset separate from goodwill and to amortize it over the expected useful life of the purchased core deposit accounts in order to reflect income clearly.

In *Citizens and Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd per curiam*, 900 F.2d 266 (11th Cir. 1990), the Tax Court, in a reviewed decision, held that the core deposit intangible was an amortizable intangible asset. Rejecting the government's contention that the core deposit intangible was goodwill as a matter of law, the Tax Court applied the rule of *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), that amortizability is a question of fact. The Tax Court found that the core deposit intangible had (1) an ascertainable cost basis separate and distinct from goodwill, and (2) a limited useful life which can be ascertained with reasonable accuracy.[1]

In *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3rd Cir. 1991), the Third Circuit misread the Tax Court's opinion in *Citizens and Southern*. Contrary to statements in the Third Circuit's opinion, the Tax Court is not part of "a minority strand amid the phalanx of cases." 945 F.2d at 565. Instead, the Tax Court explicitly follows the rule of *Houston Chronicle* that amortization is a question of fact. By choosing to abandon the rule of *Houston Chronicle* in favor of a new *per se* rule of law, it is the Third Circuit which has adopted a minority view in conflict with every other circuit which has considered the issue since *Houston Chronicle*.

Of greater concern, however, is the Solicitor General's request to abandon the rule of *Houston Chronicle* in favor of a proposed *per se* rule that would apply to all assets in all industries. Although pointedly having chosen not to ask this Court two years ago to review the fully developed factual record in *Citizens and Southern*, the Solicitor General now proclaims that *Citizens and Southern* is inconsistent with the suggested *per se* rule, and invites the Court to overrule it in this case, when none of those facts are before the Court. Brief for the United States on a Petition for a Writ of Certiorari at 13-15.

The ABA believes that its views will be of assistance to the Court in deciding whether the rule of *Houston*

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[1] After *Citizens and Southern*, a memorandum decision was entered in *Colorado National Bankshares, Inc. v. Commissioner*, 60 T.C.M. (CCH) 771 (1990), *appeal docketed*, No. 91-9019 (10th Cir. Sept. 27, 1991). Following the Third Circuit's opinion below, the Tax Court in *IT&S of Iowa, Inc. v. Commissioner*, TAX CT. REP. (CCH) (97 T.C. 496) 4550 (Nov. 12, 1991), and *Peoples Bancorporation v. Commissioner*, TAX CT. MEM. DEC. (CCH) (63 T.C.M.) 3028 (May 18, 1992), reaffirmed the rule of *Houston Chronicle* and the amortization of core deposit intangibles.

Chronicle should be abandoned in favor of any new *per se* rule. Numerous bank acquisitions, past and present, have been consummated in reliance on existing law, in which the *Houston Chronicle* standard and its application in *Citizens and Southern* govern the amortization of intangible assets. Changing to a new *per se* rule that would deny the amortization of the core deposit intangible, an asset recognized by the banking industry, the accounting profession, the bank regulatory agencies, the Securities and Exchange Commission, and the courts to be separate and distinct from goodwill, would have a profound effect on the banking industry.

STATEMENT OF THE CASE

This case specifically concerns whether a depreciation deduction may be taken by Newark Morning Ledger Company under section 167 of the Internal Revenue Code for the portion of the purchase price of eight Michigan newspapers allocable to a "paid subscribers" intangible asset. The district court found, as a fact, that the asset had a limited useful life and, based upon the stipulation of parties, that the life could be determined with reasonable accuracy. *Newark Morning Ledger Co. v. United States*, 734 F. Supp. 176, 180-81 (D.N.J. 1990), *rev'd*, 945 F.2d 555 (3rd Cir. 1991). The district court further found, as a fact, that the asset had an ascertainable value that was separate from goodwill. 734 F. Supp. at 181-83.

Acknowledging the government's concession that the asset had an ascertainable value and limited useful life, the Third Circuit framed the issue as whether those factual findings were sufficient to satisfy the rule of *Houston Chronicle*. 945 F.2d at 559-60. The government argued that those factual findings do not mean the asset is "separate and distinct" from goodwill as the term "has been repeatedly characterized in the case law." *Id.* at 559. The taxpayer, on the other hand, argued that "properly defined, goodwill is no more than the residual value that remains after all assets with determinable useful lives and ascertainable values have been accounted for." *Id.* at 560.

After noting that there is not a "uniform or coherent definition" of the term goodwill, 945 F.2d at 559 n.5, the Third Circuit then divined two competing definitions in the case law. *Id.* at 559-567. The court contrasted descriptions of goodwill in the case law as "the expectancy that old customers will resort to the old place" and "the expectancy of continued patronage, for whatever reason" (quoting *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963) and *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962)), with a "residual" definition, purportedly applied by the Tax Court. The Third Circuit believed that the Tax Court's decisions in *Citizens and Southern* and *Colorado National Bankshares* "represent no more than a minority strand amid the phalanx of cases that have considered the definition and application of the term 'goodwill.' " *Id.* at 565. Believing instead that descriptions of goodwill as the expectancy of continued patronage are "consistent with the prevailing case law," *id.* at 568, the Third Circuit concluded that "the district court had applied the wrong definition of 'goodwill.' " *Id.*

Instead of remanding the case to the district court for further factual findings in accordance with *Houston Chronicle*, the Third Circuit agreed with the Commissioner that "there are *some* intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." *Id.* (emphasis added). In an apparent attempt to define what intangible assets comprise the "some," the Third Circuit adopted a rule of law that "[c]ustomer lists are *generally* not depreciable when acquired in conjunction with . . . a going concern." *Id.* (emphasis added).

SUMMARY OF THE ARGUMENT

Ever since the landmark decision in *Houston Chronicle*, it has been clear that there are no *per se* rules prohibiting depreciation of intangible assets. The Third Circuit, however, adopted a new *per se* rule that is utterly inconsistent with the entire modern case law of depreciation. While

purporting to rely on *Houston Chronicle*, the Third Circuit in fact has resurrected the same *per se* rule of law advanced by the government and rejected by the Fifth Circuit in that case.

In fashioning its *per se* rule, the Third Circuit ignored or mischaracterized the case law, particularly *Citizens and Southern Corp. v. Commissioner*, 91 T.C. 463 (1988), *aff'd per curiam*, 900 F.2d 266 (11th Cir. 1990). *See infra* note 5 and accompanying text. In that case, the Tax Court applied the *Houston Chronicle* test, and found as a fact that the core deposit intangible was separate and distinct from goodwill as that term is interpreted in the case law. 91 T.C. at 480-500. The record in *Citizens and Southern* showed that the core deposit intangible was valued as a separate asset in determining the purchase price of a bank, trades separately in the marketplace, and was required to be treated as a separate asset for financial and regulatory accounting purposes in order to reflect income clearly. *Id.* at 495-500.

Neither the Third Circuit nor the Solicitor General offers any cogent reason why decades of established law should be jettisoned in favor of a new rule which makes illogical and artificial distinctions among different wasting assets. There is no reason for the Court to accept this invitation to depart from established law. Rather than put an end to current litigation,the suggested new rule would only promote further litigation as the government and taxpayers wrestle about its applicability, scope, and significance for other assets in diverse factual settings, all without the benefit of existing case law. Moreover, the Court does not have before it the record to fashion a *per se* rule to apply to all assets in all industries.

This Court is effectively being asked to adopt what amounts to a legislative solution to what the Solicitor General describes as "a substantial volume of litigation in the past and present." Brief for the United States on Petition for a Writ of Certiorari at 15. Congress is currently considering legislation that would resolve disputes over the

depreciation of intangible property, just as Congress acted in the past to resolve disputes over the depreciation of tangible property, by providing a uniform period for the amortization of all intangible assets. This legislation was recently described by the Treasury Department as "the centerpiece of our simplification efforts." Statement of Fred T. Goldberg, Jr., Assistant Secretary (Tax Policy) Department of the Treasury, Before the Committee on Finance, United States Senate (April 28, 1992).

Absent any legislative change to the Internal Revenue Code, the determination of a "reasonable allowance for depreciation" is and should remain a question of fact.

ARGUMENT

I. THE THIRD CIRCUIT HAS ERRONEOUSLY ADOPTED THE *PER SE* RULE REJECTED BY *HOUSTON CHRONICLE*.

In *Houston Chronicle*, the taxpayer sought to amortize the value of newspaper subscription lists. Relying on the "mass asset rule," the Commissioner argued that the subscription lists were similar to goodwill and thus nondepreciable. The government's brief stated its position as follows:

> Since the nature of goodwill is the expectancy that old customers will resort to the old places and the expectancy of continued patronage . . . the term goodwill, for tax purposes, encompasses a wide spectrum of intangibles which are associated with favorable customer patronage. . . . Thus, goodwill is the sum total of all the imponderable qualities which attract customers and bring patronage to the business.

Houston Chronicle, 481 F.2d at 1248 n.5. The court, however, rejected "the establishment of a *per se* rule . . . that would amalgamate all subscriptions lists with goodwill." *Id.* at 1253.

In *Newark Morning Ledger*, however, the government argued, and the Third Circuit agreed, that there is a *per*

se rule that "[c]ustomer lists are generally not depreciable when acquired in conjunction with the sale of an underlying business as a going concern." 945 F.2d at 568. Indeed, the government argues, and the Third Circuit seems to agree, that the *per se* rule should apply to any terminable-at-will contract or noncontractual relationship acquired in conjunction with the purchase of an ongoing business if the value is in any way contingent upon continued customer patronage. Brief for the United States on Petition for Writ of Certiorari at 9, 15; *Newark Morning Ledger*, 945 F.2d at 560, 569. It is unfathomable, however, how the government or the Third Circuit can maintain that any *per se* rule is not only consistent with, but in fact supported by, the holding in *Houston Chronicle* that there are no *per se* rules.

In embracing the government's *per se* rule that customer lists acquired in connection with an ongoing business are generally not depreciable, the Third Circuit ignores the factual situation present in *Houston Chronicle*. The Third Circuit asserts that: "In the context of the sale of a going concern, it is simply often too difficult for the taxpayer and the court to separate the value of the list *qua* list from the goodwill value of the customer relationships." *Id.* at 568. In contrast, "the Service argues that, unlike the present dispute, *there was no goodwill transferred in the acquisition of the assets of Houston Chronicle* and thus no risk that goodwill would be bound up and depreciated along with the subscriber list." *Id.* at 562 (emphasis added). Moreover, in *Houston Chronicle* the taxpayer "did not purchase an ongoing business . . . but rather the idle assets of the defunct *Houston Press*." *Id.*

What the government misstated, and the Third Circuit overlooked, is that goodwill was transferred in the acquisition in *Houston Chronicle*, along with virtually all of the operating assets of an ongoing business. Despite the government's contention below that there was no goodwill transferred in *Houston Chronicle*, 945 F.2d at 562, the Fifth Circuit's opinion clearly recites that the jury allocated $775,400 (or 17 percent of the purchase price) to

goodwill. 481 F.2d at 1244. Furthermore, the purchaser, the *Houston Chronicle*, acquired the land, improvements, fixtures, inventory, equipment, library, and subscription lists owned by the seller, the *Houston Press*. *Id.* at 1243. In addition, the purchaser obtained a ten-year covenant not to compete from both the *Houston Press* and its parent newspaper chain, the E.W. Scripps Company. *Id.*[2] The only asset apparently not transferred was the right to use the Scripps-Howard "light-house design." *Id.* at 1243 n.2. The *Houston Press* did not stop publication until March 20, 1964, the day the purchase agreement was announced to the general public. *Id.* at 1244.

Moreover, the government's professed belief that *Houston Chronicle* supports its proposed *per se* rule conflicts with its inconsistent positions in subsequent litigation. Just a few years after *Houston Chronicle*, the government argued unsuccessfully in *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978), that *fixed-term* contracts were goodwill as a matter of law. Although rebuffed by the Fifth Circuit once again in *Laird*, the government has continued to argue that fixed-term contracts are nonamortizable simply because the value may be contingent on "expected customer patronage." *See, e.g.*, *Ithaca Industries, Inc. v. Commissioner*, TAX CT. REP. (CCH) (97 T.C. 253) 4439 (Aug. 12, 1991) (government argued unsuccessfully that favorable yarn supply contracts were inseparable from goodwill and going concern value); *Business Services Industries, Inc. v. Commissioner*, 51 T.C.M. (CCH) 539 (1986) (government argued unsuccessfully that Muzak customer contracts were inseparable from goodwill).[3] The government has also continued to argue

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[2] The fact that the purchaser required a ten-year covenant not to compete from the seller, which was valued by the jury at $1,809,400 (or approximately 40 percent of the $4.5 million purchase price), 481 F.2d at 1244, plainly contradicts the government's characterization of the seller as "defunct."

[3] The Third Circuit wrongly believed that "the Service does not dispute, that value of the paid subscribers would not constitute goodwill

that customer lists are inextricably linked with goodwill as a matter of law even if they are *not* acquired in connection with an ongoing business. *See, e.g., Panichi v. United States*, 834 F.2d 300 (2d Cir. 1987) (per curiam); *Midlantic National Bank v. Commissioner*, 46 T.C.M. (CCH) 1464 (1983).

The government's actual position, although it is understandably reluctant to admit it, is that *Houston Chronicle* was wrongly decided and that all "customer or market-based intangibles" should be nonamortizable. Distinctions based on stated contract terms, or based on acquisition as part of an ongoing business, have been made by the government on a case-by-case basis, solely dependent upon the facts of the particular case it is then litigating. To date, the government has been singularly unsuccessful. Until the decision of the Third Circuit below, no circuit court had agreed with the government's argument that *Houston Chronicle* supported any *per se* rule. *Citizens and Southern Corp. v. Commissioner*, 900 F.2d 266 (11th Cir. 1990), *aff'g per curiam*, 91 T.C. 463, 479 (1988); *Decker v. Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988); *Southern Bancorporation, Inc. v. Commissioner*. 847 F.2d 131, 136-37 (4th Cir. 1988); *Panichi v. United States*, 834 F.2d 300, 301 (2d Cir. 1987); *McCarthy v. United States*, 807 F.2d 1306, 1310 (6th Cir. 1986); *Ralph W. Fullerton Co. v. United States*, 550 F.2d 548, 550 (9th Cir. 1977); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 452 (Ct. Cl. 1976).[4]

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if Morning Ledger's 'expectation of continued patronage' were contractually-based." *Newark Morning Ledger*, 945 F.2d at 560.

[4] Indeed, prior to this case, there had been only one case involving the amortization of intangible assets, decided in the 20 years since *Houston Chronicle*, in which a circuit court reversed the trial court. In that case, *Southern Bancorporation, Inc. v. United States*, 732 F.2d 374 (4th Cir. 1984), *cert. denied*, 469 U.S. 1207 (1985), the district court's decision was not reversed on the basis of any *per se* rule of nonamortizability, but on the fact-specific ground that the acquirors' attempt to increase the basis of the loan portfolios was "wholly *post-hoc*."

II. THIS CASE SHOULD NOT BE USED TO OVERTURN SETTLED LAW HOLDING THAT CORE DEPOSIT INTANGIBLE ASSETS WERE SEPARATE AND DISTINCT FROM GOODWILL.

The concern of the American Bankers Association, as amicus curiae, is that the Solicitor General is improperly asking the Court to use this case as a vehicle to overturn *Citizens and Southern* and other cases holding, as a matter of fact, that core deposit intangible assets were separate and distinct from goodwill. Those cases, however, are not before the Court. The government chose not to seek this Court's review of the Eleventh Circuit's affirmance of an exhaustive 51-page opinion which carefully considered all of the government's *per se* arguments but instead based its decision, in accordance with *Houston Chronicle*, on a factual record consisting of the testimony of 15 witnesses and hundreds of documents. This Court should decline the Solicitor General's invitation to overrule a fact-based decision of the Tax Court involving a different intangible asset in a different industry. This case should not be used to question or usurp the factual determination in other cases that the core deposit intangible asset is an asset that is separate and distinct from goodwill.

A. The Third Circuit Mischaracterized the Tax Court's Opinion in *Citizens and Southern*.

Although claiming that the Tax Court applied the "wrong" definition of goodwill, the Third Circuit declined to distinguish *Colorado National Bankshares* and *Citizens and Southern*, stating that "such an exercise ultimately would prove pointless and . . . disingenuous." *Newark Morning Ledger*, 945 F.2d at 565.[5] The fundamental flaw

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[5] The Third Circuit's original opinion, issued on September 12, 1991, did not even mention *Citizens and Southern*, which was decided by the Tax Court three years earlier, on September 6, 1988, 91 T.C. at 463, and affirmed by the Eleventh Circuit on March 22, 1990. 900 F.2d at 266. On October 15, 1991, the Third Circuit issued a revised opinion to include references to *Citizens and Southern*, 945 F.2d at 564 n.7a, 565, and 567, and to delete the statement in its original opinion that

in the Third Circuit's analysis is the erroneous assumption that the Tax Court has adopted or applied a different definition of goodwill.

Even a cursory review of *Citizens and Southern* makes it plain that the Tax Court has *not*, contrary to the statements in the Third Circuit opinion, collapsed the *Houston Chronicle* standard into a test whereby the showing of limited useful life satisfies the "separate and distinct" requirement. In fact, the Tax Court specifically rejected that position because it:

> fails to consider the case law interpreting goodwill within the meaning of the regulation. As a threshold matter, petitioner must establish that deposit base is an asset separate and distinct from goodwill as that term is interpreted in the case law.

Citizens and Southern, 91 T.C. at 480.[6] Accordingly, the Tax Court's opinion in *Citizens and Southern* spends twenty pages reviewing the record before holding that the "deposit base has an ascertainable cost basis separate and distinct from the goodwill and going-concern value." 91 T.C. at 480-500.[7] Only after satisfying this threshold question did the Tax Court turn to the separate issues of limited useful life and ascertainable value. *Id.* at 500-05, 505-10.[8]

"the Service submits that little weight should be accorded to the Tax Court's opinion in *Colorado National* since it is only a memorandum decision, the Service has not yet exhausted its appeals, and the Tax Court relied heavily upon the reasoning of the district court in the instant case in reaching its result."

[6] In each of its subsequent opinions involving the core deposit intangible, the Tax Court has similarly addressed the threshold issue of "separate and distinct from goodwill" before turning to the issues of limited useful life and ascertainable value. *IT&S of Iowa*, TAX CT. REP. (CCH) at 4556-57; *Colorado National Bankshares*, 60 T.C.M. (CCH) at 787-89; *Peoples Bancorporation*, TAX CT. MEM. DEC. (CCH) (63 T.C.M.) at 3092-12 to -15.

[7] The factors considered by the Court included: (1) the acquisition of core deposits was an important reason for the purchase of the bank and one of the key factors that determined the purchase price; (2) deposit base is recognized as separate from goodwill for financial and regulatory accounting purposes; (3) there are different techniques for valuing deposit base, including the income method and the cost savings method; and (4) separate transfers of core deposits do occur in the marketplace. 91 T.C. at 495-500.

In short, the Third Circuit's opinion is simply wrong when it characterizes the decisions of the Tax Court as a minority strand in the case law. Instead, applying the *Houston Chronicle* standard, the Tax Court properly considered all of the evidence before making a factual determination that the core deposit intangible asset was separate and distinct from goodwill as that term has been interpreted in the case law.

B. The Core Deposit Intangible Asset Is Separate and Distinct from Goodwill.

1. Banks will pay a premium to acquire core deposits and the level of core deposits affects the purchase price.

Fundamentally, a core deposit intangible asset is separate from goodwill because it is recognized and treated as a separate asset in the banking industry. The business of banking consists of borrowing money from depositors and investing in loans to customers or making other investments. The value of core deposits arises from the use of the low-cost funds to make those income-producing loans and other investments. A bank which obtains a low-cost source of funds for a predictable period of time through

[8] Courts have recognized limited useful life as a factor in determining that an asset is separate and distinct from goodwill. *See, e.g., Illinois Cereal Mills, Inc. v. Commissioner*, 46 T.C.M. (CCH) 1001, 1023-24 (1983), *aff'd*, 789 F.2d 1234 (7th Cir. 1986), *cert. denied*, 479 U.S. 995 (1986) (cited with approval by the Third Circuit, 945 F.2d at 566); *Richard S. Miller & Sons, Inc. v. United States*, 537 F.2d 446, 452 (Ct. Cl. 1976) ("most important indication"). On occasion, the Commissioner has agreed: "Section 1.167(a)-3 of the regulations gives us the *single factor* that determines whether an intangible asset is amortizable, which is that it must have a limited useful life that can be estimated with reasonable accuracy." Priv. Ltr. Rul. 8311002 (Nov. 17, 1982) (emphasis added).

the purchase of a group of core deposits has a commercial advantage, in the form of income deriving from lower operating costs, just like a business which obtains the right to use its premises at a rent that is lower than current market rents, or a business which obtains the right to purchase raw materials at a price that is lower than the current market price.[9]

Accordingly, in determining the purchase price of another bank, the purchaser will pay a premium for the core deposits, which represent a stable source of low-cost funds for a predictable period of time. *Citizens and Southern*, 91 T.C. at 498-99; *Midlantic National Bank v. Commissioner*, 46 T.C.M. (CCH) 1464, 1465-66 (1983); *Banc One Corp. v. Commissioner*, 84 T.C. 476, 490 (1985), *aff'd mem.*, 815 F.2d 75 (6th Cir. 1987). *See also Peoples Bancorporation*, TAX CT. MEM. DEC. (CCH) at 3029-15 (a seller of deposits considered their value when estimating potential bids for bank branches).[10]

In each of the core deposit cases, however, the government has attempted to redefine the core deposit intangible asset claimed by the taxpayer as something else in order to argue that it merely represents "continued patronage." The Tax Court has explicitly rejected this argument, stating:

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[9] Bargain leases and favorable supply contracts are amortizable intangible assets. *See, e.g., KFOX, Inc. v. United States*, 510 F.2d 1365, 1378 (Ct. Cl. 1975); *Ithaca Industries*, TAX CT. REP. (CCH) at 4449; *Dalton v. Commissioner*, 21 T.C.M. (CCH) 435, 438-39 (1962). Although lease obligations, contract obligations, and core deposits themselves are liabilities, these decisions held that the benefit of below-market liabilities is an asset. *See also Dickman v. Commissioner*, 465 U.S. 330, 337 (1984) ("The right to the use of $100,000 without charge is a valuable interest in the money lent, as much so as the rent-free use of property consisting of land and buildings. In either case, there is a measurable economic value associated with the use of the property transferred. The value of the use of money is found in what it can produce.").

[10] In *Peoples Bancorporation*, the purchase agreement included a price adjustment if there was a material change in the level of deposits between the date the agreement was signed and the date of closing. TAX CT. MEM. DEC. at 3029-3.

> [P]etitioner is not attempting to depreciate the value of the [acquired] bank's customer structure or the expected value of continued patronage of the [acquired] bank's established clientele, 91 T.C. at 499; rather, it seeks to amortize only one separate component of the value petitioner acquired when it purchased the [acquired] bank, namely, the core deposits. While the [acquired] bank's customer structure may have had many more elements of value, which petitioner hoped to exploit, petitioner did not attempt to take those elements into account in calculating the amortization value of the deposit core. For instance, the prospect of selling as many banking services as possible to the customers of the acquired bank was a significant consideration in petitioner's decision to acquire the [acquired] bank, but the potential value of such opportunity did not figure in the calculations with respect to the deposit core.

IT&S of Iowa, TAX CT. REP. at 4556-57.

2. Core deposits trade separately in the marketplace.

Banks often buy the core deposits of failed banks separately from any other asset. *Citizens and Southern*, 91 T.C. at 498; *Peoples Bancorporation*, TAX CT. MEM. DEC. (CCH) at 3029-2 ("deposits are sometimes purchased separately from any other assets; the FDIC has done this in resolving insolvencies of troubled banks"); *see also Midlantic National Bank*, 46 T.C.M. (CCH) at 1475 (right to solicit deposits of a failed bank held to be an amortizable intangible asset). In recent litigation, even the Commissioner has admitted and stipulated that core deposits trade separately in the marketplace.[11] Although the tax law does

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[11] In *Trustmark v. Commissioner*, Docket No. 18372-89 (T.C filed July 18, 1989), the government stipulated that:

> During the late 1980's and including the present time, banks have and can bid for and acquire the deposit liabilities of failed thrift institutions through the RTC. In such transactions, the

not require separate sales to establish that an intangible asset has determinable value separate from goodwill, *Citizens and Southern*, 91 T.C. at 492-93 (discussing *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977) and *KFOX, Inc. v. United States*, 510 F.2d 1365 (Ct. Cl. 1975)), there can be no clearer proof of separateness than the fact that bankers frequently can and do buy core deposits independently of any other asset.

3. Generally Accepted Accounting Principles and Regulatory Accounting Principles Require Core Deposit Intangibles To Be Recorded As Separate From Goodwill.

The core deposit intangible asset is not some abstract concept invented by banks for tax purposes, but a *mandatory* application of financial and regulatory accounting principles. Because the core deposit intangible has a definite useful life which can be estimated with reasonable accuracy, a bank's income will be overstated unless the amortization expense of the core deposit intangible is matched with the income derived from loans and other investments.

Under generally accepted accounting principles ("GAAP"), banks are *required* to record the core deposit intangible asset as a separate asset for financial reporting purposes and to amortize it over its useful life.[12] Because the book method clearly reflects income, Section 446 of

bank pays money to assume the deposit liabilities. In such circumstances, the bank may or may not purchase any other assets or properties of the thrift institutions.

[12] *See, e.g., Citizens and Southern*, 91 T.C. at 496-97 (discussing Accounting Principles Board Opinion No. 17, Intangible Assets (Aug. 1970); Financial Accounting Standards Board Interpretation No. 9, Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method (Feb. 1976); Financial Accounting Standards Board Statement No. 72, Accounting for Certain Acquisitions of Banking or Thrift Institutions (Feb. 1983)).

the Internal Revenue Code requires banks to amortize the core deposit intangible. I.R.C. § 446(a)-(b).[13] Although a GAAP method is not always controlling for tax purposes,[14] the amortization of core deposit intangibles is required because it clearly reflects income.[15]

The agencies which regulate banks and bank holding companies, including the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Securities and Exchange Commission, likewise require that the core deposit intangible asset be recorded as a separate asset and amortized over its useful life for regulatory accounting purposes.[16] Bank regulators *mandated* the treatment of the core de-

[13] Treas. Reg. § 1.446-1(a) provides:

> Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any *item*. . . . These methods of accounting for special items include the accounting treatment prescribed for . . . *depreciation*.

Id. (emphasis added).

[14] In *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), for example, the inventory method used by the taxpayer for book purposes failed to reflect income clearly as required by Treas. Reg. § 1.471-2(a)(2).

[15] As noted by the Fifth Circuit in *Houston Chronicle*: "The concurring opinion of then-Circuit Judge Blackmun makes clear, if the asset is shown to be a wasting one used in taxpayer's trade or business, a reasonable deduction must be allowed." 481 F.2d at 1251 (discussing *Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128 (8th Cir. 1960)).

[16] *See, e.g., Citizens and Southern*, 91 T.C. at 497-98 & nn. 17-19 (discussing Office of the Comptroller of the Currency, Interim Policy with Respect to the Accounting Treatment for Purchased Core Deposit Intangible, Banking Circular No. 164 (Dec. 1981); Office of the Comptroller of the Currency, Accounting for Intangible Assets, Banking Circular 164-Revised (July 1985); The Securities and Exchange Commissioner's Staff Accounting Bulletin No. 42, Application of Existing Accounting Standards to Business Combinations Accounted for by the Purchase Method Involving Financial Institutions (Dec. 23, 1981)).

posit intangible asset as a separate asset because "its amortization was necessary in order to avoid distorting a bank's income." *IT&S of Iowa, Inc.*, TAX CT. REP. (CCH) at 4557 (discussing the testimony of Robert Storch of the FDIC).

Where, as in the case of core deposit intangible assets, "a taxpayer's generally accepted method of accounting is made compulsory by the regulatory agency *and* that method clearly reflects income, it is almost presumptively controlling of federal income tax consequences." *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 15 (1974). Moreover, particular weight is given to the regulatory pronouncements of *bank* regulatory agencies because of their special expertise and close scrutiny of banks. *NCNB Corp. v. United States*, 684 F.2d 285, 293 (4th Cir. 1982) (*en banc*); *Colorado Springs National Bank v. United States*, 505 F.2d 1185, 1188 (10th Cir. 1974).

In summary, the records considered by the Tax Court in *Citizens and Southern*, *Colorado National Bankshares*, *IT&S of Iowa*, and *Peoples Bancorporation* proved as a factual matter that the core deposit intangible assets acquired by those taxpayers were separate and distinct from goodwill. The separate and distinct nature of the core deposit intangible asset is just one example demonstrating why there cannot be a blanket rule purporting to address different types of assets in different industries.

III. THE RULE OF *HOUSTON CHRONICLE* SHOULD NOT BE REPLACED BY *PER SE* RULES

A. The Case Law Does Not Support Any *Per Se* Rules.

The Third Circuit's opinion cites numerous decisions that purportedly "have considered the definition and application of the term 'goodwill' in the context of [Treas. Reg.] section 1.167(a)-3." *Newark Morning Ledger*, 945 F.2d 565-

66.[17] The Third Circuit found it necessary to review just a "few of these cases" in deciding to adopt its *per se* rule. *Id.* at 566. The Third Circuit's *per se* rule, however, is not supported by the few cases discussed in its opinion, nor by any of the other post-*Houston Chronicle* cases concerning the amortization of intangible assets.

The Third Circuit's opinion relies mainly on *General Television, Inc. v. United States*, 449 F. Supp. 609 (D. Minn. 1977), *aff'd*, 598 F.2d 1148 (8th Cir. 1979) (per curiam), and *AmSouth Bancorporation v. United States*, 681 F. Supp. 698 (N.D. Ala. 1988), the only post-*Houston Chronicle* cases cited by the Third Circuit which even intimate that there are any *per se* rules. The Third Circuit's interpretation of those two district court opinions, however, has been discredited by subsequent decisions in their respective circuit courts.

Although the Third Circuit's opinion mentions the Eighth Circuit's opinion in *Donrey, Inc. v. United States*, 809 F.2d 534 (8th Cir. 1987), it fails to note that the Eighth Circuit explicitly clarified that *General Television* does not stand for the proposition that terminable-at-will contracts acquired as part of an ongoing business are non-depreciable as a matter of law:

> The District Court in General Television simply applied the same test as used herein [the *Houston Chronicle* test] and reached a different conclusion based on different facts. *It does not entitle the government to judgment as a matter of law*, nor does it compel us to conclude that the instant subscription list is non-depreciable goodwill.

Donrey, 809 F.2d at 537 (emphasis added). The Third Circuit's opinion dismisses *Donrey* with the startling claim

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[17] Curiously, although the Third Circuit concluded that the Tax Court uses the "wrong" definition of goodwill, many of the cases it cites are decisions of the Tax Court. The Third Circuit simply misunderstands that the Tax Court, like other courts, recognizes that whether an asset is separate and distinct from goodwill is a question of fact.

that *Donrey* is inconsistent with *Houston Chronicle*. 945 F.2d at 563. Far from being inconsistent with *Houston Chronicle*, *Donrey* is a straightforward application of the rule in *Houston Chronicle* that entitlement to depreciation depends upon the proof of the facts and circumstance concerning useful life and value. One of the facts determined by the trier of fact (in that case a jury) was that the asset acquired by the taxpayer was separate and distinct from goodwill.[18] Accordingly, applying the *Houston Chronicle* test, the taxpayer was entitled to depreciate the value of the acquired asset over its useful life. *Accord Panichi v. United States*, 834 F.2d 300 (2d Cir. 1987) (per curiam).

The Third Circuit's opinion also relies on the district court's opinion in *AmSouth Bancorporation v. United States*, even while conceding its "doubtful validity" after the Eleventh Circuit's affirmance of *Citizens and Southern*. 945 F.2d at 567. The Third Circuit's opinion erroneously attributes the difference in outcomes to *AmSouth*'s "opting for the traditional definition of goodwill." *Id.* at 567. The Tax Court applied the same definition of goodwill in *Citizens and Southern* that the district court applied in *AmSouth*. The Tax Court found, however, that the record in *Citizen and Southern* was different from the record in *AmSouth* and thus compelled a different result. 91 T.C. at 481. The *AmSouth* court recognized that the case law in this area did not establish *per se* rules, but "only serve to emphasize the factual nature of the issue." 681 F. Supp. at 718.[19]

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[18] The Third Circuit apparently believed that *Donrey* may be explained by "the substantial deference due the jury's determination that the taxpayer had proved a value separate and distinct from goodwill." 945 F.2d at 563. The Third Circuit did not explain why it would not defer to a specific finding of fact by the Tax Court in *Citizens and Southern* that the core deposit intangible asset is separate and distinct from goodwill.

[19] The *AmSouth* court was careful to rest its *holding* on the taxpayer's failure of proof. The district court's *dicta* approving a *per se* rule are irreconcilable with the Eleventh Circuit's decision in *Citizens and Southern* and, as a former part of the Fifth Circuit, the controlling precedents

The Third Circuit, moreover, erroneously cites *Panichi v. United States*, 834 F.2d 300 (2d Cir. 1987) (per curiam), to support its view that *Houston Chronicle* is limited to those situations when the asset is not acquired as part of a going concern. Although *Panichi* noted that a customer list acquired separately from a going concern *may* be depreciated, it did not find that the same list acquired with a going concern can *never* be depreciable. *Id.* at 302. Moreover, the Second Circuit did not interpret *Houston Chronicle* as excluding terminable-at-will contracts whose value is based on customer patronage. In *Panichi*, the taxpayer was allowed to amortize a customer list valued on the basis of expected monthly receipts from the customers on the list. *Id.* at 301. While the facts do not state whether the contracts were terminable-at-will, that absence suggests that the Second Circuit (like all other circuits which have expressly considered the issue) would find the distinction irrelevant. In short, rather than supporting any *per se* rule, the Second Circuit recognized that "the depreciability of an intangible asset under this [*Houston Chronicle*] standard is largely a question of fact, dependent upon the circumstances in each case." *Id.*[20]

Unsupported even by the cases cited for authority, the Third Circuit's new *per se* rule is directly contrary to the

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of *Houston Chronicle* and *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978).

[20] The Third Circuit has similarly misread the decision in *Robins & Weill, Inc. v. United States*, 382 F. Supp. 1207 (M.D.N.C. 1974). The district court did not interpret *Houston Chronicle* to establish a *per se* rule based on whether the asset was purchased as part of an ongoing business. Instead, the district court noted that "the depreciability of expiration lists is a factual question to be decided after the taxpayer has been given an opportunity to meet the dual test laid down in *Houston Chronicle*." 382 F. Supp. at 1213. The court then found the allocation of ten dollars to goodwill in the purchase agreement to be inadequate, and having no other basis on which to make an allocation, determined that the taxpayer had failed to prove its case. *Id.* at 1215. Nothing in the opinion supports the Third Circuit's *per se* rule that would deny a taxpayer the *opportunity* to carry its burden of proof under the *Houston Chronicle* test.

holdings of *Citizens and Southern*, 900 F.2d 266; *Donrey*, 809 F.2d 534; *Super Food Services, Inc. v. United States*, 416 F.2d 1236 (7th Cir. 1969);[21] and *First Pennsylvania Banking & Trust Co. v. Commissioner*, 56 T.C. 677 (1971), *acq.* 1972-1 C.B. 2.[22] These cases, among many others, *see supra* text accompanying note 4, all recognize that whether an intangible asset is separate from goodwill is a question of fact. In each of these cases, amortization was permitted for terminable-at-will contracts acquired as part of an ongoing business whose value is dependent upon continued customer patronage.

B. The Proposed *Per Se* Rule Is Unworkable.

1. The proposed rule will only promote uncertainty and further litigation.

A *per se* rule that "customer lists are *generally* not depreciable when acquired in conjunction with the sale of the underlying business as a going concern," will not resolve existing controversies but will instead promote additional uncertainty and further litigation.[23] Without a clear articulation of *all* the circumstances in which this "general" rule would and would not apply, neither taxpayers nor the government will be able to determine the applicability of the rule without further litigation.

The Solicitor General's attempt to frame a *per se* rule even more broadly, to deny amortization to all "customer and market-based intangibles" whose value is contingent on the "expected future patronage of its existing non-contractual customers," Brief for the United States on Petition for a Writ of Certiorari at 9, 15, would invite even more litigation. This rule is so amorphous that it defies definition.[24] The boundaries of dispute would merely shift as taxpayers and the government disagree about whether a particular situation involved "contractual relationships," whether the purchase was in "conjunction with an ongoing business," and whether the asset was linked to "expected future patronage from customers."

The American Bankers Association, as amicus curiae, is concerned that the government would attempt to rely on a *per se* rule to deny amortization to many intangible assets long recognized as separate and distinct from goodwill. For example, ever since the depreciability of mortgage servicing rights was established in a series of cases more than twenty years ago, not even the government has questioned the principle that mortgage servicing contracts

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[21] In *Super Food*, as in *Citizens and Southern* and other cases, the fact that separate consideration was given to the asset in the purchase decision demonstrated that the asset was separate from goodwill. 416 F.2d at 1239 (separate value of the contracts considered in the purchase decision). *See, e.g., Business Services Industries, Inc. v. Commissioner*, 51 T.C.M. (CCH) 539, 543 (1986) ("The separate and distinct nature of the value of the location contracts is readily apparent from the fact that the bank was willing to finance the purchase of the stock by BSI with the contracts being used as the only collateral."); *Seaboard Finance Co. v. Commissioner*, 23 T.C.M. (CCH) 1512 (1964), *aff'd*, 367 F.2d 646 (9th Cir. 1966) (loan contracts individually valued).

[22] In *Citizens and Southern*, the government claimed that *First Pennsylvania* was distinguishable "because the taxpayer was assured the use of a fixed amount of funds over a fixed period of time pursuant to a formal written contract which it acquired." 91 T.C. at 489. That contention, however, "is simply not supported by the facts. The taxpayer was not assured the use of a fixed amount of funds for a fixed period of time. The lenders could terminate the service agreements by simply giving written notice." *Id.*

[23] "If the Supreme Court were to adopt the government's position that, as a matter of law, customer lists are intertwined with goodwill and cannot be amortized, I think you will still find that there are an unlimited number of controversies in this area." Testimony of Fred T. Goldberg, Jr., Assistant Secretary (Tax Policy) Department of the Treasury, Before the Committee on Finance, United States Senate at 21 (April 28, 1992).

[24] The scope of the requested rule is hardly limited to a customer-based intangible, particularly in light of the Solicitor General's reference to the entire premium paid by a purchaser over the value of the *tangible* assets as "this premium associated with the going concern value or goodwill of the business." Brief for the United States on the Petition for Writ of Certiorari at 15.

are depreciable intangible assets.[25] Given the government's inconsistent litigating positions in *Laird*, *Panichi*, *Ithaca Industries*, and *Business Service Industries*, there is every reason to expect that the government will try to redefine any rule adopted by this Court in the same manner that it has attempted to redefine the rule of *Houston Chronicle*.

2. The proposed rule does not help the finder of fact determine what is a reasonable allowance for depreciation.

The Solicitor General's assumption that a *per se* rule would avoid recurring factual disputes is wrong. Rather, trial courts still would need to make the same sort of factual determinations currently required by *Houston Chronicle*.

For example, a *per se* rule making a distinction between fixed-term contracts and terminable-at-will contracts does not aid the finder of fact. Even if the contracts have fixed terms, the trial court must still determine whether the asset has a useful life which can be determined with reasonable accuracy. The Third Circuit wrongly believes that taxpayers depreciate "the value of those contracts over that time period." *Newark Morning Ledger*, 945 F.2d at 560. Instead, trial courts must first determine whether the contract will be renewed. If the contract will be renewed, the trial court must determine whether the useful life is indefinite or can be estimated with reasonable accuracy despite the renewals. *Compare Uecker v. Commissioner*, 81 T.C. 983, 993-998 (1983) (renewable fixed-term grazing privileges had an indefinite life), *with Business Services*, 51 T.C.M. (CCH) at 540, 543 (renewable five-year Muzak contracts held to have a 15-year useful life). Accordingly, despite the proposed rule, trial courts must still examine

[25] *See, e.g., First Pennsylvania*, a case in which the Commissioner acquiesced twenty years ago. Armed with a new *per se* rule, the Commissioner could once again try to argue that mortgage servicing rights acquired in connection with a going concern are nonamortizable because they are somehow linked to "future customer patronage."

fixed-term contracts on a case-by-case basis to determine useful life.[26]

Despite the proposed *per se* rule, trial courts will continue to be required to determine what assets are separate from goodwill. The *Houston Chronicle* standard has never meant that the asset in question must be an orphan, free from all relation to or contact with any element a court has ever described as part of the goodwill of a particular business.[27] Indeed, the value of many depreciable assets, including tangible assets, is dependent upon continued customer patronage.[28] Unless the rule is interpreted so broadly

[26] The need for the finder of fact to determine useful life, not simply the term of the contract, explains why courts have not made the distinction between terminable-at-will and fixed-term contracts. Neither the Third Circuit nor the government offers any reason why a distinction should be drawn between a terminable-at-will contract and a 30-day contract, both of which have a useful life of five years.

[27] As the Fifth Circuit stated in *Laird v. United States*, 556 F.2d 1224, 1234 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978): "That the assets contribute value to one another does not prevent their severability for tax purposes. . . . This is so even if the assets are worthless without one another." The Seventh Circuit has described *Laird* as having "settled" the question of the depreciability of intangible assets purchased in a bundle of interrelated assets. *Selig v. United States*, 740 F.2d 572, 575 n.9 (7th Cir. 1984).

[28] Concurring in *Citizens and Southern*, Judge Cohen put it best:

> I have found no authority for the proposition that assets, intangible or tangible, are not separate and distinct from goodwill unless no part of their value is related to continued patronage of customers of an ongoing business. As the majority opinion demonstrates in its exhaustive analysis of relevant authorities, assets are frequently found to be eligible for amortization even though the price paid took into account the probable continuance of terminable business relationships. . . . Tangible property, such as special purpose equipment, is unquestionably subject to depreciation even though its value may be enhanced by its use in an ongoing business. It seems to me that the requirement that an asset be separate and distinct means only that it must have a measurable value for a specific use.

91 T.C. at 515-16 (Cohen, J., concurring) (citations omitted).

as to deny amortization to all assets, tangible or intangible, which derive any part of their value from "future customer patronage," trial courts will not be aided in their determination by the *per se* rule proposed by the Solicitor General.

Finally, the proposed distinction between two identical assets based solely on whether the asset is acquired as part of an ongoing business does not simplify the factual determination. The government argued below and the Third Circuit agreed that the taxpayer in *Houston Chronicle* "did not purchase an ongoing business." Nonetheless, the finder of fact in *Houston Chronicle* still was required to allocate the purchase price among goodwill and the identifiable intangible assets including a customer list. Making the distinction proposed by the Third Circuit, therefore, does nothing to relieve the Third Circuit's concern that it is "often too difficult" for the court to determine a separate value for intangible assets. 945 F.2d at 568.

Perhaps no question is more peculiarly a question of fact than determining the fair market value of an asset. In its opinion, the Third Circuit intimates that its decision may have been different if the taxpayer had valued the asset using a different *appraisal technique*. Perhaps in that case, it seems, the "paid subscribers" intangible asset would have an ascertainable value separate and distinct from goodwill.[29] It is beyond dispute, however, that the trier of fact must be the one to determine valuation issues based on all of the evidence, including the experience in the industry, testimony of taxpayers and appraisers concerning market comparables, replacement cost, discounted cash flow, cost savings, or any other valuation issues brought before it.[30] If the trial court in fact applied the

[29] The suggestions by the Third Circuit that a different factual finding by the district court as to the value may have lead to a different result illustrates the fallacy inherent in the *per se* approach adopted by the court.

[30] It is the function of the trial court, not the appellate court, to judge the credibility of witnesses, to weigh the evidence, and to draw appropriate inferences. *Hamm v. Commissioner*, 325 F.2d 934, 938 (8th Cir. 1963), *cert. denied*, 377 U.S. 993 (1964). "An appellate court's powers of review are limited 'and that limitation is particularly narrow when the issue is one of value.'" 325 F. 2d at 938 (quoting *Sisto Financial Corp. v. Commissioner*, 149 F.2d 268 (2d Cir. 1945)).

wrong definition of goodwill, the proper remedy would be to remand, not to speculate about valuation issues on appeal, nor to adopt a *per se* rule that would prevent other taxpayers from having an opportunity to prove that other intangible assets do in fact have an ascertainable value separate from goodwill.

Until the decision below, trial courts have applied the rule of *Houston Chronicle* for twenty years and no circuit court has found it necessary to substitute any *per se* rules. The other circuit courts have recognized that depreciation can only be determined on a case-by-case basis because what constitutes "a reasonable allowance" will vary from one situation to another. Absent a change in the law to deny amortization for intangible assets, or to provide uniform amortization periods as was done previously for tangible assets, decades of settled law should not be abandoned to adopt the rule suggested by the Solicitor General.

IV. ANY CHANGE IN THE LAW REGARDING THE AMORTIZATION OF INTANGIBLES SHOULD BE MADE BY CONGRESS

Several years ago, Congress considered and rejected proposed legislation that would have enacted the rule the Solicitor General has proposed. Section 10120 of H.R. 3545, the Revenue Bill of 1987, proposed to deny amortization of subscription lists and other intangible assets. Although H.R. 3545 was enacted as Title X of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, 1330-382 (1987), Congress did not enact the provision denying amortization of subscription lists and other intangible assets and has not enacted any of the more recent proposals to deny amortization of intangible assets.

Last year, Representative Dan Rostenkowski, Chairman of the House Ways and Means Committee, introduced pro-

posed legislation that would resolve the recurring factual disputes over the depreciation of intangible assets by statutory means. Rather than denying depreciation of certain intangibles by imposing any *per se* rule, H.R. 3035, 102nd Cong., 1st Sess., 137 CONG. REC. 5908 (1991), instead would eliminate the factual disputes necessitated by current law by permitting businesses to amortize all customer-based intangible assets, *including goodwill*, over a period of fourteen years.

The Rostenkowski bill was the subject of a congressional hearing on October 2, 1991, at which both the Treasury Department and American Bankers Association testified in support of the bill's enactment. In the Treasury Department's testimony, Assistant Secretary (Tax Policy) Kenneth W. Gideon indicated that:

> Commissioner Goldberg and I believe that H.R. 3035, which requires amortization of purchased goodwill and other intangible assets over 14 years, is one of the most important simplification proposals before you this year. If enacted, it would avoid innumerable tax controversies concerning the tax treatment of future acquisitions.

Statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury, Before the Committee on Ways and Means, United States House of Representatives at 1 (Oct. 2, 1991).

On March 20, 1992, Congress passed the "Tax Fairness and Economic Growth Acceleration Act of 1992," which included the 14-year amortization period for goodwill and other intangible assets. H.R. 4210, § 4501 (Mar. 20, 1992).[31]

[31] The final tax bill, H.R. 4210, was modified to include a retroactivity provision which would permit taxpayers to make an across-the-board election to amortize over a 17-year period. Treasury Department officials viewed this provision as unnecessary because they believed that current controversies could be settled on the same basis as the proposed legislation. Statement of Fred T. Goldberg, Jr., Assistant Secretary (Tax Policy) Department of the Treasury, Before the Committee on Finance, United States Senate at 4-6 (April 28, 1992).

Although the Act was vetoed by President Bush, the veto was not triggered by the intangibles simplification provisions. *See* Tax Fairness and Economic Growth Acceleration Act of 1992-Veto Message from the President of the United States, 138 CONG. REC. H1604 (Mar. 24, 1992).

On April 28, 1992, current Assistant Secretary for Tax Policy, Fred T. Goldberg, Jr., testified before the Senate Finance Committee and reaffirmed the Treasury Department's support for a legislative solution. Mr. Goldberg testified:

> The legislation you are considering is the product of more than 18 months of cooperation among the Congress, the Administration, and the private sector. In many respects, it is the centerpiece of our simplification efforts. It is not perfect—but there is no such thing as the perfect law. It is fair and reasonable; it achieves its stated objectives and is consistent with fundamental principles of sound tax policy; and it is a dramatic improvement over the current state of affairs.

Statement of Fred T. Goldberg, Jr., Assistant Secretary (Tax Policy) Department of the Treasury, Before the Committee on Finance, United States Senate at 2 (April 28, 1992).

The primary justifications offered by the Solicitor General in support of his *per se* rule are the "substantial volume of litigation past and present" and the "more than $4 billion of [proposed] adjustments in cases involving the depreciation of customer or market-based intangible assets." Brief for the United States on Petition for a Writ of Certiorari at 15-16. Those concerns are fully addressed by the current legislative efforts to simplify intangible asset depreciation. There is no reason for this Court to accept the Solicitor General's invitation to depart from established law.

CONCLUSION

The Third Circuit's decision in this case appears to hold that, as a matter of law, a customer list is generally not depreciable when acquired in conjunction with the sale of the underlying business as a going concern. That holding is contrary to existing law and should be reversed. If there was any error by the trial court in applying the *Houston Chronicle* standard, the Third Circuit should have remanded to the trial court for further findings of fact.

If the Court should decide *this* case in favor of the United States, however, the American Bankers Association respectfully submits that the Court is not required to expand its holding beyond the "paid subscribers" asset at issue in this case. There is no reason to adopt the broad *per se* rule advanced by the Solicitor General. Absent a legislative change to the Internal Revenue Code, depreciation is a question of fact, and the factual record in this case should not be used to decide the depreciability of any other asset. The record in this case should not be used to decide the depreciability of intangible assets acquired in other newspaper acquisitions, much less the depreciability of intangible assets in other industries, such as the core deposit intangible.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

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On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF AMICUS CURIAE OF FREDERIC W. HICKMAN, K. MARTIN WORTHY AND BRADFORD L. FERGUSON IN SUPPORT OF PETITIONER

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Frederic W. Hickman, K. Martin Worthy and Bradford L. Ferguson, with the consent of all parties, submit this brief *amicus curiae* pursuant to Rule 37.2 of the Rules of this Court in support of petitioner Newark Morning Ledger Co.

I. INTEREST OF THE *AMICI CURIAE*

Identity of the *Amici*

This brief is submitted on behalf of the following individual tax practitioners, each of whom previously served in major posts in the Department of the Treasury:

Frederic W. Hickman, Assistant Secretary of the Treasury for Tax Policy, 1972-1975

K. Martin Worthy, Chief Counsel, Internal Revenue Service, 1969 - 1972

Bradford L. Ferguson, Special Assistant to the Assistant Secretary for Tax Policy, 1977-79, Associate Tax Legislative Counsel, 1979 -1980

The views expressed are the personal professional views of the *amici*. This brief is neither authorized nor financed by any client.

Purpose of the Brief

The purpose of this brief is to alert the Court to practical aspects of the tax system which, when combined with a judicial determination in this kind of case, could produce bad tax policy.

The taxpayer petitioner is not in a position to raise these matters with authority and the Department of Justice is unlikely to do so for reasons that will appear.

On balance the matters that we wish to call to the Court's attention support the position of the taxpayer.

II. SUMMARY OF ARGUMENT

The Court should not assume that the government's position here represents a fully considered policy position of the Treasury Department or advances an important goal of the tax system. The government's acquiescence in the petition for certiorari appears to have been made without high level coordination with the Treasury and is inconsistent with major tax policies being pursued by the Treasury.

In order for the Court to adopt the government's position, the Court would need to redefine the word "goodwill". For a court to use a single case to launch a definition is very risky where, as in this case, the definition must apply to a very large universe of other situations, which vary enormously in character and none of which is before the court. It is especially undesirable for Supreme Court decisions to launch new definitions in such a circumstance because there is so little opportunity to adjust the definition as other factual situations are presented. New definitions in such cases should be left to legislation or regulatory procedures, where the broad range of facts can be taken into account.

Legislation is in progress, strongly supported by the Treasury, that would eliminate nearly all disputes of this kind over the amortization of intangibles, including "goodwill". The legislation would relieve the courts, the government and the taxpayers of the burdens of controversy and litigation. A Court decision -- for either party -- cannot achieve that overall result. A Supreme Court decision for the government is, for the reasons explained, likely to derail the legislative effort.

The fact that legislation is in progress would not be a reason for rejecting the government's position here if the law were clearly as the government asserts. But the law is preponderantly to the contrary and legislation provides the best avenue for the resolution of any remaining issues.

Where an asset is shown to be subject to exhaustion in the business over a determinable life, there is no room for construing the language of section 167 of the Internal Revenue Code of 1986 (26 U.S.C.) as inapplicable. The language of the regulation referring to "goodwill" does not purport to require that result and there is no reason to so construe it.

Amortization of the intangibles in issue here is clearly the right answer on analytical, tax policy grounds. Recent Treasury testimony confirms that amortization of intangibles is proper as a matter of tax policy, even in instances where the intangible has an indeterminate life. Where, as here, the trial court's findings of fact determine "the period over which the value disappears" there is no principled ground whatever for denying the amortization deductions prescribed by section 167 of the Internal Revenue Code.

III. ARGUMENT

Aspects Not Addressed

This brief does not discuss the 70 years of case law dealing with "intangibles" (including "goodwill") and their amortization or non-amortization. We assume that will be adequately covered by the parties and other *amici*.

This brief does, however, proceed on the assumptions, which we believe to be correct, that:

- The Internal Revenue Code (section 167) provides generally that in arriving at net taxable income the cost of a business asset that is subject to exhaustion over time shall be offset against revenues through deductions for depreciation or amortization during the life of the asset.

- Treasury regulations interpreting section 167 provide that "goodwill" may not be depreciated or amortized. There has never been a clear and consistent definition of "goodwill". Court cases talk broadly of "goodwill" as linked to continued patronage. But in the absence of more specificity, the lack of a determinable life has become the defining characteristic of "goodwill".
- Over roughly the last twenty years, the courts have increasingly, but not invariably, permitted amortization of intangibles in cases where the intangible could be identified and valued and statistical evidence was sufficient to make a reasonable projection of its "life". (Statistical projection is the classic method of "lifing" assets, whether tangible or intangible. In recent years schedules of lives for broad classes of tangible assets have been prescribed by legislation.) The recent development of computers that can apply advanced statistical methodologies to large data bases has made possible the "lifing" of intangibles that could not, as a practical matter, previously be lifed.
- The court cases are instances in which the IRS contested amortization of an intangible. On balance they support the taxpayer here. However, the court decisions are only part of the story. It is our opinion, based on professional observation and experience, that, in the great majority of taxpayer audits, amortization has been allowed, in the amount claimed or in compromised amount, where estimated lives and values have been supported by data of the kind described. However, intangibles for which no reliable estimates could be made have remained as unamortizable "goodwill".

- The permutations and combinations in which intangibles are found in different businesses are myriad.

The Problem of Judicial Lawmaking in Tax Cases Like This

The government, in effect, seeks in this case (1) a new definition of goodwill that would include subscription lists and (2) a holding that an intangible falling within the boundaries of that definition is non-depreciable even though it is subject to exhaustion over a determinable life.

We assume that other briefs will demonstrate why a Treasury regulation, if construed to preclude amortization of an intangible that is subject to exhaustion over a determinable life, would be an impermissible interpretation of the statutory language.

We wish to make, rather, a more general point about the process of judicial law making. It is that, given the near-infinite variety of intangibles that exist, it is not possible to define "goodwill" satisfactorily in a single case involving a single intangible and a single transaction. Too much is outside the record.

It is not entirely satisfactory even to "prick out" the boundaries of a definition in a series of factual decisions. A clear sense of the universe involved would require weeks of evidence and inquiry. It cannot be [illegible]ned in appeals with tight page limits on briefs and oral arguments.

To make this point is not to criticize the judicial process, but only to recognize that there are problems best left to other procedures and institutions.

In the case of intangibles that are individually identified, valued and lifed, if some are nonetheless to be treated as non-amortizable because they fall within the new definition of

"goodwill" sought by the government, and are thus "inseparable" from "goodwill", how would the boundaries of the new definition be described? Even slight changes in the nature of an intangible may raise major questions in any attempt to formulate a rule. For example, an ordinary subscription like those involved here, is a kind of contract, terminable at will, between the taxpayer and the subscriber. Suppose the contract is for a specific period, not terminable at will. Should the result be the same? Should it make a difference: how many contracts there are? whether they are likely to be renewed? if it is clear they will not be renewed? whether there are likely to be new contracts with other parties? whether the contracts acquired become more profitable or less profitable as time passes? whether the new contracts are as profitable as the old contracts? exactly what kind of contract is involved, *e.g.*, a contract to provide services, or sell goods, or not compete, or to have the right to operate in a certain way or in a certain place?

One cannot safely promulgate a general definition in a case involving one contract without thinking through how the rule would operate in other contexts for other kinds of contracts and for all the kinds of intangibles that are not contracts.

The Special Problem of Supreme Court Decisions in the Tax Area

In addition to the general problems of judicial rulemaking in this kind of tax case, there are special problems that may be created by Supreme Court decisions dealing with tax issues.

The Internal Revenue Code is the lengthiest, most complex, most internally interrelated statute on the books today. It implements a highly specialized system of both law and administration. It deals principally with the determination of "income", a subject whose complexities have been debated extensively by academics for decades and have engaged the

continuous attention of the entire accounting profession. In consequence, there is in the tax area a larger than usual danger that a decision in one case may have unintended implications affecting many other, seemingly unrelated, cases.

Court decisions that produce unintended consequences are an inevitable incident of the judicial process and create mischief wherever they occur. However they are more or less correctable if they occur in the lower courts, as the points can be relitigated in other courts or even in the same court.

But Supreme Court decisions are different. They do not get relitigated. And because they are the "final word" and because the Court ordinarily takes tax cases on *certiorari* in order to settle a rule, the language of the Court's tax conclusions and reasons have come to be very precisely parsed by taxpayers and tax officials alike. The Court's language is treated almost as if it were statutory language. That is unfortunate, for the opinions are surely not written to be treated as statutes. But that is, in fact, what happens today.

The potential for Supreme Court decisions to create havoc in the tax area is well illustrated by the Court's 1988 decision in *Arkansas Best*. (*Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988).) The transaction at issue was an unusual one and the parties argued, *inter alia*, from statutory language of very general applicability, relevant to an enormous universe of ordinary business transactions. The Court was not apprised by counsel of the implications of the statutory language in other contexts, in particular for "hedging" transactions of a kind routinely entered into by thousands of business taxpayers. Nor was the Court advised of the interrelationship of that language and the design of the Internal Revenue Code with respect to "hedging" transactions, as revealed in other Code sections.

For transactions like the more or less out-of-the-ordinary transaction at issue in *Arkansas Best* the Court's decision

settles the law. But the Court's language completely unsettled the law for myriads of previously "garden variety" hedging transactions entered into by many businesses in the ordinary course. Dozens and dozens of articles, speeches and seminars have since been devoted to the new problems created by the language of the opinion and what to do about it.

The Treasury initially made efforts to restore sensible results in the hedging area. It devoted months to an attempt to devise new rules, but ultimately no rules were issued. Treasury apparently concluded that, given the language of the opinion, it could not get to the desired end without leaving itself open to the accusation that it was giving up Treasury revenues without authorization.

Hedging by businesses, including the massive hedging of the kind indispensable to major financial institutions and much of the hedging on the commodities exchanges that exist to facilitate business hedging, is now in limbo. It seems probable that this Court, if and when the hedging issue ultimately comes back before it, would limit or modify the problem language and reach a correct result. But meanwhile, rules that evolved over decades and that were satisfactory to both the Treasury and to the businesses involved lie in doubt and discredit.

The Court cannot be expected to know these things on its own. Realistically, private litigants, even if competent to educate the Court about larger contexts, are not likely to use their limited space and time to do so. The Court must necessarily rely on the government to exercise sound judgment in deciding what tax issues to bring to the Court and how to argue them. *Arkansas Best* shows that the government does not always meet that test. But even under the best of circumstances, the lesson exemplified by *Arkansas Best* is that a single case is a most unreliable context in which to forge new principles or definitions that will be applicable to a wide variety of different factual situations.

Judicial Rulemaking Versus a Legislative Solution for This Kind of Case

Like *Arkansas Best*, the case before the Court is one thread in an extensive web. While the case must be decided, one way or the other, it is a dangerous vehicle for promulgating new, generally applicable definitions applicable to such a large and variable field of facts. The legislative or regulatory arenas are much better places than the courts to formulate definitions cutting through such an extensive universe. The legislative and regulatory processes include opportunities for all interested parties to explain the universe of situations potentially affected.

The Treasury Department and the Congress are currently engaged in a legislative effort to deal with intangibles generally, including "goodwill". The process has been lengthy because there is so much diverse input, and so many taxpayers and kinds of intangibles are potentially involved. Treasury Assistant Secretary Goldberg testified:

> The legislation you are considering is the product of more than 18 months of cooperation among the Congress, the Administration, and the private sector.

Statement of Hon. Fred T. Goldberg, Jr., Assistant Secretary (Tax Policy), Department of the Treasury, Hearings before the Senate Committee on Finance, 102d Cong. 2d Sess., (April 28, 1992) (hereafter "*Goldberg Statement, Finance Hearings*") p. 2.

The proposed legislation is itself testimony to the difficulty of making definitions that would seek to separate some kinds of intangibles from other kinds. It avoids most definitional problems by prescribing a single class, with a single average "life", for virtually all intangibles.

Ironically, for reasons that will be described, a Supreme Court decision for the Treasury on the grounds urged by the Department of Justice in the Third Circuit below could well destroy the legislative effort, strongly supported by the Treasury, to put in place a comprehensive system for dealing with intangibles, including "goodwill" (however defined).

The Formulation of Tax Policy by the Executive Branch

In order to understand how tax cases come to this Court and to evaluate whether the Treasury, as an institution, regards them as important, it is necessary to understand the institutional processes involved.

Within the Executive branch of the government, the development of the tax law is primarily the responsibility of the Treasury Department, and particularly of the Internal Revenue Service and the office of the Assistant Secretary for Tax Policy. To the extent the tax law is developed in litigation, the Department of Justice is also involved.

The primary administration of the tax system lies with the Internal Revenue Service. The "grand design" of system concepts (as distinguished from administrative approaches and procedures) lies with the office of the Assistant Secretary. That office is concerned with the overall development of the rules, whether in legislation, in regulations, in generally applicable rulings, or in litigation policies (as distinguished from -- but not always inseparable from -- the disposition of the liabilities of particular taxpayers). The office of the Assistant Secretary comprises approximately 70 professionals, with a roughly equal number of economists and lawyers. An important function of the office is to estimate the revenue effects of tax changes and to make budget projections with respect to total government revenues.

All cases tried in Article III courts are tried by the Department of Justice. Cases tried in the Federal district

courts and in the United States Claims Court are handled by the Tax Division of the Department of Justice and all tax appeals are under the jurisdiction of the Solicitor General with the assistance of the Tax Division.

Most tax cases, however, originate in the Tax Court. It is not an Article III court and cases there are tried by lawyers from the office of the Chief Counsel for the Internal Revenue Service.

These arrangements bring together formidable resources and on the whole have worked well. However, the overlapping roles described inevitably give rise to turf battles and, when coordination is relaxed, permit significant matters to fall in the cracks. That appears to have happened in this case. It appears that the acquiescence by the Department of Justice in the taxpayer's petition for certiorari received no more than pro forma attention at the top tax policy levels of the Treasury.

The job of good litigators is to win cases. Government tax litigators are not unresponsive to tax policy considerations, but it is not the litigator's function to spend much time thinking about how the tax system should operate and how the case he or she is trying fits into the grand design. In short, once litigation is authorized and passes into the hands of the litigators, it tends to take on a life of its own. That is perhaps even more true for cases tried by Justice lawyers in the Article III courts than for cases tried by IRS lawyers in the Tax Court because the Justice lawyers are further removed than IRS lawyers from the IRS and Treasury offices concerned with the larger aspects of tax administration and policy.

The Department of Justice formally coordinates its tax litigation with the Treasury through the Office of Chief Counsel for the Internal Revenue Service. But there is not close coordination on a day-to-day basis, and given the volume

of cases involved, most "coordinating" moves through lower level channels at the Internal Revenue Service without close attention from senior officials. On appeal, cases commenced in the Tax Court are likely to be followed more closely by the Chief Counsel's Office than cases commenced in the U.S. Claims Court or in a district court (as in this case) because the Tax Court cases were tried by personnel in the Office of Chief Counsel, who are familiar with them and have a stake in their outcome.

Because this case was commenced in a Federal district court, it has been handled throughout by Department of Justice lawyers. Periodic communication between Justice and the Office of Chief Counsel presumably occurred. But cases involving the amortization of intangibles have been generally viewed as turning on their particular "facts and circumstances" and there is no reason to suppose that the case was regarded as sufficiently out of the ordinary to cause it to be followed closely at policy levels of the Internal Revenue Service or the office of the Assistant Secretary.

The government won in the Third Circuit and, in retrospect, Treasury would be better off if the case had been left there.

It was the taxpayer that petitioned for certiorari here. The Department of Justice acquiesced in the petition and the Court's decision to grant it was presumably influenced by that acquiescence.

The Treasury now finds itself in an untenable position. Winning this case on the grounds argued by the government in the Third Circuit would -- paradoxically, but probably -- destroy the chance of enacting pending legislation that would provide an overall legislative solution for the amortization of intangibles, including goodwill. The legislation (H.R. 4210, section 4501), sponsored by Ways & Means Chairman Rostenkowski, has passed the House and is strongly supported

by the Treasury. Treasury testimony before the Senate Finance Committee in April 1992, characterized it as "the most important simplification measure under consideration by the Congress". *Goldberg Statement, Finance Hearings*, p. 1.

In sum, the government's litigation process in this case has slipped free from its tax policy moorings.

The Legislation Jeopardized

The Rostenkowski bill would prescribe uniform lives for the vast majority of intangibles, including goodwill. If enacted, the tax treatment of intangibles would be enormously simplified. The recurring multitude of fact intensive controversies over the nature, value and lives of intangibles would be eliminated in one fell swoop. The Internal Revenue Service would be relieved of an enormous volume of audit issues and the courts would be freed of a very large volume of controversies involving the tax treatment of intangibles. IRS Commissioner Fred Goldberg[1] described the magnitude of the controversies that would be cleared up by the legislation as follows:

> We can describe this systemic problem both statistically and anecdotally. By our best and most recent count, we estimate that there are over 8.5 billion dollars of proposed adjustments in Examination, Appeals, and Counsel case inventories, involving over 2,000 separate intangible asset issues in several hundred cases.

Tax Treatment of Intangible Assets: Hearings before the House Committee on Ways and Means, Serial 102-76, 102d Cong., 1st Sess. (hereafter "*Ways and Means Hearings*") 49

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[1]Mr. Goldberg later became Assistant Secretary (Tax Policy), Treasury Department.

(1991) (statement of Hon. Fred T. Goldberg, Jr., Commissioner of Internal Revenue).

It is not clear whether the legislation, which has already passed the House and is pending in the Senate, would apply retroactively or only prospectively. Even if it did not apply retroactively, the Treasury has indicated that it would greatly facilitate the disposition of controversies with respect to past years, presumably by establishing parameters within which the Internal Revenue Service and taxpayers could reach settlements. Thus Assistant Secretary Gideon testified:

> . . . I think that it's simply a fact, if you look at history, that if you adopt this rule on a prospective basis, it's likely to have an impact on the inventory of disputes still out there.
>
> Reverting to my first role in Government service, I think if I were the chief counsel and such legislation were passed, I'd certainly take into account what Congress had done with the future, in terms of deciding my settlement pattern with respect to my existing inventory.

Ways and Means Hearings, 54 (statement of Hon. Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury).

Mr. Gideon and Mr. Goldberg described the great importance they attached to the legislation, as follows:

> Commissioner Goldberg and I believe that H.R. 3035, which would require amortization of purchased goodwill and other intangible assets over 14 years, is one of the most important simplification proposals before you this year. If enacted it would avoid innumerable tax controversies concerning the tax treatment of future acquisitions.

Ways and Means Hearings, 33 (statement of Hon. Kenneth W. Gideon).

> This bill, in sum, is an opportunity to take a quantum leap in the direction of good tax administration.

Ways and Means Hearings, 51 (statement of Hon. Fred T. Goldberg, Jr., Commissioner of Internal Revenue).

Given the importance the Treasury attaches to the pending legislation and given current Congressional budget procedures, this appeal puts the Treasury and the IRS in a no-win position.

If the government loses this appeal, it has gained nothing. It should not have supported appeal in the first place.

But if the government wins, the likely result is even worse. A win would only settle things for selected items, and the pending legislation -- which would clear up the whole intangibles area and is much more important in the grand scheme of things than this case -- becomes much more difficult, if not impossible to secure. That is because the legislation, heretofore supported as "revenue neutral", becomes a "revenue loser". Under current Congressional rules, a bill that loses revenue can be enacted only on condition that it is accompanied by a measure that raises revenue -- a near fatal condition for a bill of this kind in the present budgetary and political climate.

The "revenue loser" problem arises because the revenue estimate of any proposed legislative change is determined with respect to an assumed baseline, namely, what existing law will produce in the absence of the change. A Supreme Court decision that requires a change in assumptions about existing law changes the baseline. The more items a Supreme Court decision renders non-deductible, the greater is the estimated

"revenue loss" from a bill that permits those same items to be deducted.[2]

The Treasury was and is concerned about this threat. At the Ways and Means hearings last October 2, Assistant Secretary Gideon had the following exchange with Congressman Donnelly:

> MR. DONNELLY [referring to this case]. * * *
>
> . . . [I]f the Court, the High Court, rules and sustains the Third Appeals Court, what revenue impact would the Chairman's legislation have then? Because you've stated that the Chairman's legislation is revenue neutral. If the Court rules and sustains the position of the Service, what revenue impact then would the Chairman's bill have?
>
> MR. GIDEON. It would be speculative for me to state. I think that would be a different world than the world that we're in.
>
> MR. DONNELLY. Could it be in the tens of billions of dollars?
>
> MR. GIDEON. I don't think it would be that significant, but it would be significant.

Ways and Means Hearings, 68.

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[2]This is a simplified statement of the principle. There are more factors involved here, but they do not change the conclusion indicated, as Mr. Gideon's remarks below corroborate. The Treasury's revenue estimation function was under Mr. Gideon's supervision, as Assistant Secretary, at the time of his remarks (and was under Mr. Hickman's supervision, as Assistant Secretary, from 1972-1975.)

The Cost of Subscriptions Should, in Principle, Be Amortized

A final note, to put the substantive issue of amortization into perspective and explain why the taxpayer's position is also the "right" position from a tax policy point of view:

There is general agreement at the Treasury and in the accounting profession that proper measurement of "income" requires that the cost of intangibles be recovered on some basis over time; that intangibles are "wasting" assets, *i.e.*, are gradually exhausted in the business; and that even the inability to determine a "life", as in the case of goodwill, should not prevent the offsetting of such costs against revenues in order to arrive at net "income". Thus Assistant Secretary Gideon testified before the House Ways and Means Committee on October 2, 1991:

> Financial accounting conventions have over time begun to require amortization or depreciation of goodwill in order to prevent financial statements from overstating assets and income. The financial accounting community has recognized that goodwill is not a perpetual asset akin to land or a fine painting, but rather that the value of goodwill and other intangible property is eventually consumed in the production of income, even though the period over which the value disappears may be indeterminate.
>
> Thus, there is a discontinuity between sound accounting practices and the tax rule that goodwill cannot be amortized.
>
> * * *
>
> [The] statistics indicate that intangible assets are more significant than in earlier years.
>
> We believe that the time has come to adopt statutory amortization rules for intangible property . . . .

Ways and Means Hearings, 29-30 (statement of Hon. Kenneth W. Gideon).

The General Accounting Office representative testified to the same effect on the same day:

> Financial accounting requires the amortization of goodwill while tax accounting does not allow it. Financial accounting requires such write-offs because goodwill is generally recognized as a wasting asset. Allowing tax deductions for the cost of all wasting intangible assets consumed by a business would improve the measurement of income and treat all forms of investment more equitably.
>
> Establishing statutory cost recovery periods would simplify useful life determinations.

Ways and Means Hearings, 76 (statement of Jennie S. Stathis, Director for Tax Policy and Administrative Issues, General Government Division, U.S. General Accounting Office).

In this case, there is no dispute that the subscribers acquired and the value ascribed to them would be exhausted, on average, over the period of years determined. The trial court so found.

No doubt the taxpayer hoped that as the acquired subscribers disappeared, new "self-created" subscriptions and subscribers would be obtained. No doubt it hoped that those new subscriptions would outnumber old subscriptions lapsed.

But new self-created subscriptions are not relevant in determining how to account for the subscriptions acquired. New subscriptions, however many may materialize, will be accounted for in accordance with the rules applicable to subscriptions self-created by newspapers generally. Under current rules most of the cost of self-created new subscriptions are expensed, rather than capitalized. As a result, when the subscriptions originally acquired have lapsed and been completely amortized, the cost of all subscriptions will have

disappeared completely from the assets reflected on the taxpayer's balance sheet, no matter however many new subscriptions remain in force. That fact appears to be the source of much of the analytical confusion.

To illustrate, assume that 100 old subscriptions are purchased for $100x and that the 100 old subscribers have been replaced by 100 new subscribers. Some are tempted to argue -- and it appears to be the government's "logic" in this case -- that nothing has happened; there are still 100 subscribers and $100x should remain on the books, unamortized.

The fallacy in the logic is seen easily the moment one moves to the less artificial assumption that one-for-one replacement is unlikely. If the 100 original subscriptions lapse and there is no replacement, it would be obvious to most observers that the original $100x should have been amortized over time. If the 100 original subscriptions lapse over time and the taxpayer purchases 100 new subscriptions from another company, but the value of a single subscription has changed so that the purchase price is $80x or $120x, it would be also obvious to most observers that the original $100x should be amortized and replaced by the new $80x or $120x, as the case might be.

In short, the old subscriptions should be separately accounted for as they disappear, and the new subscriptions should be separately accounted for as they appear.

The confusion arises when the new subscriptions are self-created. In the case of subscriptions that are self-created, the costs of solicitation and advertising, which are perhaps the chief expenditures responsible for producing subscriptions, are ordinarily "expensed", *i.e.*, treated as currently deductible "ordinary and necessary business expenses". That "expensing" treatment is a tax policy compromise between

logic and practicality and has been reexamined and readjusted over the years by both the Treasury and the Congress. In the subscription examples, expensing does produce the result, puzzling perhaps at first blush, that while the $100x is amortized as the subscriptions for which it was paid disappear, no new value appears for the asset represented by the new subscriptions. "How can it be," some ask, "that 100 subscriptions are treated as amortizable wasting assets when there are still 100 subscriptions on hand?"

The answer is that there are old, purchased subscriptions and new, self-created subscriptions and they are subject to different rules. Good accounting requires that individual items be dealt with individually to the extent practicable. The result regarded as curious is the result of the expensing treatment for the new items. Because self-created subscriptions are the norm, expensing is the generally applicable treatment. Amortization of the old subscriptions brings a purchasing taxpayer gradually into line with taxpayers generally.

IV. CONCLUSIONS

We respectfully submit that:

1. While the Court may in past years have relied on the government, as guardian of the tax system, to put tax issues in careful perspective and balance, no such reliance is justified in this particular case. The government's acquiescence in the petition for certiorari appears to have been made without high level coordination with the Treasury and is inconsistent with major tax policies being pursued by the Treasury.

2. In order for the Court to adopt the government's position, the Court would need to conclude that the word "goodwill" encompasses at least some items that have a determinable life. That conclusion entails a redefinition --

whether explicit or implicit, and whether comprehensive or partial -- of the word "goodwill". For a court to use a single case to create a definition is very risky where, as in this case, the definition must apply to very large universe of other situations, which vary enormously in character and none of which is before the court.

It is especially undesirable for Supreme Court decisions to launch new definitions in such circumstances because there is so little opportunity to adjust the definitions as other factual situations are presented.

New definitions in such cases should be left to legislation or regulatory procedures where the broad range of facts can be taken into account.

3. Legislation is in progress, strongly supported by the Treasury, that would eliminate nearly all disputes over the amortization of intangibles, including goodwill. That would relieve the courts, the government and the taxpayers of the burdens of controversy and litigation. A Court decision -- for either party -- cannot achieve that overall result. It would affect only selected intangibles and controversy would continue. A Supreme Court decision for the government would, for the special reasons explained, likely derail the legislative effort.

The fact that legislation is in progress would not be a reason for rejecting the government's position here if the law were clearly as the government asserts. But the law is preponderantly to the contrary and legislation provides the best avenue for the resolution of any remaining issues.

4. Where an asset is shown to be subject to exhaustion in the business, there is no room for construing the language of section 167 of the Internal Revenue Code as inapplicable. The language of the regulation referring to "goodwill" does not

purport to require that result and there is no reason to so construe it.

5. Amortization of the intangibles in issue is clearly the right answer on analytical, tax policy grounds, even where no determinable life can be established. As the Treasury Assistant Secretary testified last October 2, " . . . the value of goodwill and other intangible property is eventually consumed in the production of income, even though the period over which the value disappears may be indeterminate." Where, as here, the trial court's findings of fact determine "the period over which the value disappears" there is no principled ground whatever for denying the amortization deductions prescribed by section 167 of the Internal Revenue Code.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

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as successor to The Herald Company,
Petitioner,

—v.—

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF AMICUS CURIAE OF COOPERS & LYBRAND

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BRIEF AMICUS CURIAE OF COOPERS & LYBRAND

STATEMENT OF INTEREST

Coopers & Lybrand ("C&L") is a national auditing, tax consulting, actuarial and management consulting firm with 16,500 partners and employees in 98 cities throughout the United States, and with affiliated firms in over 120 countries throughout the world.

C&L provides a variety of financial and tax advisory services to thousands of business and individual clients. An important segment of its services deals with advising clients, auditing and expressing opinions on proper accounting for purchases of going businesses for both tax and financial

reporting purposes. The scope of its services includes valuations of assets (especially intangibles), allocations of purchase price and determination of appropriate depreciation and amortization periods. Approximately 10 partners and 100 other professionals are principally involved in its valuation practice, with hundreds of additional tax and accounting partners and professionals advising clients on these matters from time to time.

The instant case is of major interest to C&L as it frequently deals with goodwill, going concern value, and identifiable income-producing intangible assets in its auditing, tax and valuation practices.

SUMMARY OF ARGUMENT

The major issue before this Court is whether (a) subscriber relationships purchased as part of an on-going newspaper business, which have been identified, separately valued and which have a limited useful life are, therefore, amortizable; or, (b) as the value of such subscriber relationships is based on the income to be derived from these relationships, they are inextricably linked to nondepreciable goodwill simply because among the variety of definitions of goodwill that have evolved is one that is based upon the expectancy of continued patronage.

Undoubtedly, many of the legal and other aspects surrounding this issue will be addressed by respective counsel for Petitioner and Respondent and in the many amicus curiae briefs that can be expected.

Accordingly, this brief is devoted to certain accounting and asset valuation aspects of the instant case which, while relatively narrow in the context of the entire case, are of sufficient importance in C&L's view to bring to the attention of this Court. The principal points are summarized as follows:

ACCOUNTING ASPECTS

- In order to avoid distortion of net income by properly matching expenses to income, generally accepted accounting principles have always required the assignment of values to specifically *identifiable* intangible assets (including customer based intangible assets) acquired in a business combination accounted for as a purchase, where the value and the lives are determinable. Such assigned value must then be amortized over the period expected to be benefited by use of the asset (*i.e.*, the useful life).
- For purchases initiated after October 31, 1970, generally accepted accounting principles require that the value assigned to *unidentifiable* intangible assets (the excess of purchase price over the fair market value of identifiable assets, commonly referred to as "goodwill") be amortized over a period not to exceed 40 years.

ASSET VALUATION ASPECTS

- The valuation of the subscriber relationships under the income method, and without regard to the unreliable replacement cost valuation offered by the government, was proper under the facts and circumstances of the instant case.
- Contrary to the government's suggestion, not all customer-based intangible assets are capable of separate valuation and possess a determinable useful life—the requirements for depreciation under tax and accounting principles.

I.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES RELATED TO INTANGIBLE ASSETS ACQUIRED IN A BUSINESS COMBINATION REQUIRE ASSIGNMENT OF SEPARATE VALUES TO IDENTIFIABLE CUSTOMER RELATIONSHIPS WITH DETERMINABLE LIVES AND AMORTIZATION OVER SUCH LIVES.

A. The Authoritative Literature is clear on the basic rules.

Generally Accepted Accounting Principles ("GAAP") is a term recognized by preparers, auditors, and users of financial statements to encompass rules, conventions and procedures that define accepted accounting practice. This has resulted in a GAAP hierarchy with the pronouncements of certain designated standard setters being recognized as the "highest level." Since 1973, the highest level standard setter has been the Financial Accounting Standards Board ("FASB"), the successor to the Accounting Principles Board ("APB") of the American Institute of Certified Public Accountants ("AICPA") (1962-1973) and the Committee on Accounting Procedure of the AICPA prior to 1962. Pronouncements of one of these standard setters remain at the highest level of the GAAP hierarchy unless superseded or amended by a successor.

APB Opinion No. 16, *Business Combinations*, ("Opinion No. 16") establishes GAAP for business combinations (both poolings of interests and purchases) initiated after October 31, 1970. A pooling of interests is an accounting practice where the acquired company's recorded amounts for assets and liabilities are carried forward after the combination. It is required when certain specified criteria are met covering (1) attributes of the combining companies, (2) the manner of combining the interests of the companies and (3) the absence of certain planned transactions. All other business combinations must be accounted for as purchases. This involves the allocation of the purchase price (value of consideration given and liabilities assumed) to the assets acquired. The discussion

herein relates solely to the accounting for a business combination required to be accounted for as a purchase.

Paragraph 88(e) of Opinion No. 16 which provides specific guidance for assigning amounts to intangible assets, states: "Intangible assets which can be identified and named, including contracts, patents, franchises, *customer and supplier lists*, and favorable leases, [should be recorded] at appraised values" (emphasis added). Footnote 12 to paragraph 88(e) states: "Fair values should be ascribed to specific assets; identifiable assets should not be included in goodwill." Goodwill is the residual after the assignment of values to all other assets and liabilities acquired.

APB Opinion No. 17, *Intangible Assets* ("Opinion No. 17"), establishes GAAP for amortizing both identifiable and unidentifiable intangible assets acquired in a business combination accounted for as a purchase. Paragraph 26 of that Opinion states:

> "Intangible assets acquired as part of a group of assets or as part of an acquired company should also be recorded at cost at date of acquisition. Cost is measured differently for specifically identifiable intangible assets and those lacking specific identification. The cost of identifiable intangible assets is an assigned part of the total cost of the group of assets or enterprise acquired, normally based on the fair values of the individual assets. . . . Cost should be assigned to all specifically identifiable intangible assets; cost of identifiable assets should not be included in goodwill."

Paragraph 27 of Opinion No. 17 identifies several factors that should be considered in estimating the useful lives of intangible assets over which amortization *must* be recorded because, "The Board believes that the value of intangible assets . . . eventually disappears and that the recorded cost . . . should be amortized by systematic charges to income over the periods estimated to be benefited." Paragraph 29 of Opinion No. 17 establishes a maximum period of amortization of 40 years. Thus, current GAAP for business combina-

tions requires that *all* intangible assets, including goodwill, be amortized over their reasonably estimated useful life (not to exceed 40 years).

The conclusion to amortize all intangibles is described in paragraph 23 of Opinion No. 17 as "a practical solution." That paragraph states, "This accounting follows from the observation that few, if any, intangible assets last forever. . . . Allocating the cost of goodwill or other intangible assets with an indeterminate life over time is necessary because the value *almost inevitably becomes zero at some future date*" (emphasis added). The "practical solution" related to the need to change prior practice and to address the views of many theoreticians regarding the accounting for *unidentifiable* intangibles with an indeterminate life (*e.g.*, goodwill) because it had long been the practice in accounting for purchase business combinations that *identifiable* intangibles with a limited life be separately identified and amortized over that life.

Prior to being superseded by Opinion Nos. 16 and 17, the highest level of GAAP on accounting for intangible assets was found in Accounting Research Bulletins ("ARBs") published by the Committee on Accounting Procedure. ARB No. 24, *Accounting for Intangible Assets*, classified intangibles into type (a) and type (b) intangibles. Type (a) intangibles were described as "Those having a term of existence limited by law, regulation, or agreement, or by their nature (such as patents, copyrights, leases, licenses, franchises for a fixed term, and goodwill as to which there is evidence of limited duration)." The ARB required the cost of type (a) intangibles to be amortized by systematic charges in the income statement over the period benefited.

Type (b) intangibles were described as "Those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life (such as goodwill generally, going value, trade names, secret processes, subscription lists, perpetual franchises and organization costs)." Generally, ARB No. 24 permitted carrying a type (b)

intangible at cost until it became reasonably evident that the term of existence had become limited. At that time, it would be considered a type (a) intangible and amortization would commence over that life. The ARB also permitted amortization of a type (b) intangible when a company decided the intangible may not have a life over the entire existence of the company, but the life was not yet limited as in the case of a type (a) intangible. ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 5, "Intangible Assets," retained essentially intact the provisions of ARB No. 24.

In summary, the accounting literature, at the highest level in the GAAP hierarchy, has always required assignment of values to specifically *identifiable* intangibles acquired in a business combination accounted for as a purchase, and amortization over the estimated period to be benefited (*i.e.*, their useful life). Opinion No. 17 also requires amortization of *unidentifiable* intangible assets over a period not to exceed 40 years.

B. Determination of Useful Lives of customer relationships involves the exercise of judgment, but the theory that the lives are indefinite because they constantly renew and grow was rejected by the FASB.

While GAAP requires the identification and amortization of specifically identifiable intangibles, there is considerable judgment required in determining their useful lives. For many identifiable intangibles the lives are fixed by a statute or regulation (*e.g.*, a patent or copyright) or by a contractual provision (*e.g.*, a favorable lease). In other cases, the useful lives must be determined by reference to other factors. A customer list, it is sometimes argued, constantly renews and grows; therefore, its life may be considered indefinite. (Opinion No. 16 names a customer list as a specifically identifiable intangible, clearly establishing the APB's intent for specific identification, but judgment is still required in establishing a proper life.) However, the theory of constant renewal to justify an indefinite life for a specifically identifiable intangible was

rejected by the FASB in Statement of Financial Accounting Standards No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, which states in paragraph 41:

> "The Board disagrees with those respondents who stated that intangible assets attributed to deposit accounts and customer relationships generally have indefinite lives. Those respondents viewed such relationships as being constantly renewed and growing and, therefore, indicated that a 40 year useful life may often be appropriate. [This statement recognized that APB Opinion No. 17 had already established a maximum life for GAAP.] The Board notes that Interpretation 9 [FASB Interpretation No. 9, *Applying APB Opinion Nos. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*] refers to intangible factors representing the capacity of *existing* accounts to generate future income or new business. The Board recognizes that many enterprises purchase a banking or thrift institution with the expectation of maintaining and even expanding the existing customer base and, thereby, the value of the related intangible asset; however, only purchased intangible assets are capitalizable under present generally accepted accounting principles. The Board believes that the cost and useful life of acquired intangible assets should not reflect the cost and expectations of developing, maintaining, or restoring such intangibles after they are acquired."

Thus, the FASB has refuted the constant renewal theory as an argument for an indeterminate life. The ability to maintain and/or grow the asset should *not* be a factor when evaluating the life of an acquired intangible.

A review of disclosures in the annual reports of public companies reveals that many have allocated a value to a customer list acquired in a business combination. Selected examples are attached as an Appendix to this Brief. In those instances when a short life is assigned to a customer list, the

customer appears to be a specifically identifiable end user/consumer. Examples include subscribers to publications, clients of employment agencies, and homeowner/business users of specific services. Companies whose products are sold generally through distribution networks, where demand for products (and the ultimate value of the "customer" that was acquired) is determined by an unidentifiable end user/consumer, such as the newsstand purchasers in the instant case, often do not assign an amount or a shorter life to a customer list. In the latter cases, valuation of the "list" and determination of a life are, arguably, inseparable from other unidentifiable intangibles.

II.

THE INCOME METHOD OF VALUATION IS THE MOST APPROPRIATE METHOD TO VALUE CUSTOMER-BASED INTANGIBLE ASSETS.

Typically, when a going business is acquired, the purchase price is set based upon the expected net income productivity of the target enterprise's asset base.

Notwithstanding the expected net income focus in arriving at the overall purchase price, the tax laws and accounting rules require that the underlying categories of acquired assets be valued individually. This must be done in order to determine their adjusted cost bases so that there can be a proper matching of income and expense, including computations of gains and losses on dispositions, deductions for write-offs and write-downs, and deductions for depreciation and amortization.

It can be readily seen that, in the context of the acquisition of an on-going business, the tax laws and accounting rules necessarily impose a scenario where the seller and buyer implicitly negotiate a price for each asset. All relevant facts and circumstances must be taken into account.

The obvious starting point in determining the fair market value of a particular asset is to ascertain the price at which

an identical or sufficiently comparable asset could have been acquired in an accessible market. If reliable market data is unavailable, however, two questions must be answered:

1. What would be the cost of reconstructing a sufficiently comparable asset?

2. In the case of an income-producing intangible asset, what is the properly capitalized value of the asset in view of the stream of net income it can be reasonably expected to generate?

It is important to note that *both* questions must be asked and, *if possible*, both must be answered. If proper values can be adequately demonstrated under *both* the replacement cost and income methods, the lower value must prevail. If, on the other hand, an asset can be satisfactorily valued under only one of these two methods, that method—and that method alone—is sufficient to establish the asset's value. That value is not affected simply because a different amount is calculated under another *inadequate* method. *Buffalo Tool & Die Mfg. Co., v. Commissioner*, 74 T.C. 441, 452 (1980); 42 T.C.M. 841.

An income method is frequently used to value assets in the absence of market valuation data, especially intangible assets having a close nexus to income production. The income method is theoretically sound because it is bottomed on the same factors used to arrive at the overall purchase price for the business, *i.e.*, income flow. It is noteworthy that the *IRS Valuation Guide for Income, Estate and Gift Taxes* explicitly states that, "the actual or prospective income factor takes precedence over any other factor in valuing intangibles" (p. 13, 102-105). Indeed, in the instant case, the income method was optimal since the subscriber relationships were easily identifiable, and the tenure of their relationships along with expected revenues and offsetting costs were capable of projection with reasonable certainty. In contrast, as the district court found, there was insufficient data to apply a replacement cost method.

III.

NOT EVERY CUSTOMER-BASED INTANGIBLE CAN BE ASCRIBED A USEFUL LIFE AND VALUE BY AN EXPERT

Contrary to the government's suggestion, not every customer-based intangible can be ascribed a useful life and value by an expert.

In order to depreciate an intangible asset it must (i) be identifiable; (ii) be capable of valuation; and, (iii) possess a determinable life. In many situations, however, one or more of these requirements for depreciation will either be absent or not factually supportable by the taxpayer. For example, customer relationships arising from newsstand sales *cannot* be specifically identified. In C&L's experience, customers were identified but their purchases were too sporadic and unpredictable to reasonably ascertain either the duration of the relationships or the value of the relationships (based on their net income stream). In other instances, customers were identifiable and their purchases were regular and predictable, but the future loss of such customers was not reasonably predictable (based upon objective evidence) and, therefore, the customer relationships did not have determinable lives. In all such circumstances, the assets are not depreciable.

Respectfully submitted,

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APPENDIX

APPENDIX

Following are examples of public companies that disclose in their annual reports ("ARs") the allocation of purchase price to acquired customer lists or similar intangibles and disclose an amortization period for such intangibles that is shorter than 40 years:

- AKORN INC.; 6/30/90 AR: "The excess of the purchase price over the net assets acquired was allocated to certain intangible assets (primarily customer lists) and is being amortized using the straight-line method over five years."
- BROWNING FERRIS INDUSTRIES INC.; 9/30/90 AR: "The cost over fair value of net tangible assets of acquired businesses is amortized on the straight-line method over periods not exceeding 40 years. Other intangible assets, substantially all of which are customer lists and covenants not to compete, are amortized on the straight-line method over their estimated lives, typically no more than seven years."
- CHARLES SCHWAB, CORPORATION (THE); 12/31/90 AR: "Customer lists are amortized on a straight-line basis over periods from four to fifteen years."
- CHESAPEAKE UTILITIES CORPORATION; 12/31/90 AR: "Intangible assets include . . . goodwill, customer lists . . . associated with the acquisition of non-utility companies, and are being amortized on a straight-line basis. . . . Customer lists . . . 12 years."
- COM SYSTEMS INC. 12/31/89 AR: "As part of the acquisition, the Company recorded customer acquisition costs of $1,368,000 which are being amortized over a four year period. . . . Customer acquisition costs and excess cost over net tangible assets acquired are amortized on a straight-line basis over their esti-

mated useful lives of four years and twenty-five years, respectively."

- DEP CORPORATION; 7/31/86 AR: "The total cost of the acquisition was $4,381,000. . . . Of this amount, $300,000 was allocated to the acquisition of the Natures Family customer list and is being amortized over 5 years. The remainder of the excess of cost over assets acquired, $2,343,000, is being amortized over forty years."

- DIVERSIFIED HUMAN RESOURCES GROUP INC.; 12/31/89 AR: "Intangible assets are amortized on the straight-line method over their estimated useful lives which range from three to ten years (see Notes 3 and 4)." Note 4 identifies customer lists as one of the intangible assets.

- FIRST CHICAGO CORPORATION; 12/31/90 AR: "Goodwill, representing the cost of investments in subsidiaries and affiliated companies in excess of the fair value of net assets acquired, is amortized on a straight-line basis over periods ranging from 10 to 25 years. . . . Other intangible assets, such as the value of acquired customer lists . . . are amortized using various methods over the periods benefited, ranging from 3 to 17 years."

- FLORIDA EMPLOYERS INSURANCE COMPANY (THE); 12/31/89 AR: "Included in the assets purchased were the customer lists and expiration records which disclose when policies issued by Walton are scheduled to expire. These "Expirations" are considered proprietary and $728,800 of the initial acquisition cost has been allocated to this intangible asset. . . . The value assigned to the customer list and expiration records acquired with the purchase of the assets of Walton Insurance Services, Inc. is being amortized over a ten year period, based upon the expected attrition rate of the acquired book of business."

- LIN BROADCASTING CORPORATION; 12/31/89 AR: "This acquisition will be accounted for using the purchase accounting method. . . . Amounts allocated to customer lists will be amortized over seven years and amounts allocated to licenses and goodwill will be amortized over forty years."

- NATIONAL HEALTH LABORATORIES INCORPORATED; 12/31/90 AR: "Intangibles, consisting of goodwill and other intangibles (i.e., customer lists and non-compete agreements), are being amortized on a straight-line basis over a period of 40 years and 25 years, respectively."

- PARK COMMUNICATIONS INC.; 12/31/90 AR: "Intangible assets are stated at cost and consist of subscription lists, advertising contracts . . . and excess of cost over net assets acquired. Intangible assets other than excess of cost over net assets acquired, are being amortized by the straight-line method over estimated lives ranging primarily from 7 to 20 years. . . . Excess of cost incurred since October 31, 1970 is being amortized by the straight-line method over a period of 40 years."

- PIONEER HI-BRED INTERNATIONAL INC.; 8/31/89 AR: "Intangible assets, primarily goodwill and customer lists, are stated at amortized cost and are being amortized by the straight-line method over four to ten year periods."

- PRONET INC.; 12/31/90 AR: "Other assets include goodwill and customers lists, patents and software purchased for internal use which are being amortized straight-line over five to ten-year periods."

- READICARE, INC.; 2/28/86 AR: "Acquired intangible assets consist primarily of patient records, customer lists . . . and the excess of cost over acquired net assets in conjunction with various acquisitions. Such assets are amortized using the straight-line

method over their estimated useful lives, ranging from 3 to 40 years."

- SHAKLEE CORPORATION; 12/31/88 AR: "Intangible assets, which are related to acquisitions of businesses, primarily consist of customer mailing lists, patents and trademarks and are being amortized using the straight-line method over their estimated lives ranging from 5 to 40 years."
- SIERRA SPRING WATER COMPANY; 12/31/86 AR: "Purchased customer lists are amortized using the straight-line method over periods of 10 to 15 years representing the estimated term of service to established customers in the respective service areas. . . . Goodwill represents costs in excess of net assets of businesses acquired and is being amortized using the straight-line method over 40 years."
- STAFF BUILDERS INC.; 2/28/91 AR: "Intangible assets also include customer lists, trademarks and non-compete agreements, which are generally amortized over a three to eight year period on a straight-line basis."
- THACKERAY CORPORATION; 12/31/89 AR: "Among the assets acquired are the following intangible assets, each of which is being amortized using the straight-line method. . . . Customer list . . . 10 years."
- TUSCARORA PLASTICS INC.; 8/31/90 AR: "Of the purchase price, $1,400,000 was allocated to the machinery and equipment and $350,000 to the value of customer lists. . . . The $350,000 is included in other assets and is being amortized over five years."
- UNIFIRST CORPORATION; 8/25/90 AR: "Customer lists are amortized over a seven to sixteen year period. Goodwill is amortized over periods of up to forty years."

- UNIFORCE TEMPORARY PERSONNEL INC.; 12/31/90 AR: "On July 25, 1988, the Company acquired certain assets including licensing and franchise agreements, customer lists . . . and other intangible assets of Employers Overload (EO), a temporary services company. . . . The acquisition was accounted for using the purchase method of accounting. . . . The purchase price has been allocated to the various assets purchased and is being amortized over a five-year period which approximates their expected useful lives."
- WAVERLY PRESS INC.; 12/31/87 AR: "Intangible assets, including subscription lists and publication rights, are carried at their assigned cost at acquisition date, less accumulated amortization of. . . . Such costs are amortized on a straight-line basis over the expected life of the publications, not to exceed a period of 10 years."

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No. 91-1135

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1991

NEWARK MORNING LEDGER COMPANY,
as successor to The Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF OF AMERICAN BUSINESS PRESS AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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BRIEF OF AMERICAN BUSINESS PRESS AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF THE *AMICUS CURIAE*

American Business Press ("ABP") is the association of the nation's leading business and trade magazines. Over 600 trade, scientific, professional, educational and other specialized periodicals circulated within the United States and throughout the world are published by ABP's members. Examples of ABP's member publications include the *American Journal of Medicine*, *Billboard*, *Heavy Duty Trucking*, *Industry Week*, *Iron Age*, *Medical Economics*, *Progressive Architecture*, *Pulp & Paper*, *Railway Age*, and *Ward's Auto World*.

Like the newspaper owned by Petitioner, these publications are sustained primarily by advertising. ABP periodicals receive income derived from a combination of paid subscriptions and advertising revenue like the Petitioner, or derived from a combination of paid subscriptions and requests received from readers interested in receiving the publication. All ABP publications develop their subscriber lists by focusing circulation efforts on a particular industry or profession.

ABP submits this brief in support of Petitioner to provide a practical example of why the decision of the Third Circuit should be reversed. Just as with the Petitioner's publication, subscriber lists of specialized journals have a readily determinable value and a limited useful life which can be distinguished from goodwill. As has been recognized by the Fifth Circuit in *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1253 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), and by the Eighth Circuit in *Donrey, Inc. v. United States*, 809 F.2d 534, 536 (8th Cir. 1987), determinations about the deductibility of particular subscriber lists should be fact-specific. The ruling of the Third Circuit effectively establishes a *per se* rule which would preclude publishers from proving that their subscriber lists are intangible assets which have ascertainable value separate and distinct from goodwill.

SUMMARY OF ARGUMENT

Because the useful lives of specialized subscription lists can be determined, and because they can be valued, and because such lists are separate and distinct from goodwill, they should be allowed amortization, just as the Petitioner's list should be allowed amortization. Any other result would

overstate the true net income of the publications and would lead to unfair taxation.

ARGUMENT

I. INTRODUCTION

The business world is made up of distinct fields of endeavor, and the persons engaged in these fields require news and information to stay informed and in touch with the developments in their respective endeavors. Specialized business periodicals serve the purpose of disseminating that news and information. The editorial content of these periodicals is designed and written to be of interest and value to the people working in the particular field.

The publisher of the specialized periodical, through an extensive, and costly, process of research, identifies the key people in the field--those who should want to read the publication. These potential subscribers, once identified, are solicited to become subscribers to the publication. The subscription may be a paid subscription or it may be a request subscription with the subscriber filing with the publisher a detailed, signed request setting forth the reasons why the requestor should receive the periodical. [1] Specialized business

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[1] Under the Domestic Mail Classification Schedule established by the U.S. Postal Rate Commission pursuant to 39 U.S.C. § 3623, periodicals paid for or requested by more than fifty percent of their recipients qualify for second class mailing rates. *See* 39 C.F.R. Ch. III, Pt. 3001, Subpt. C, App. A, Sec. 200.010 through 200.0110 (1991). See also, Opinion and Recommended Decision, U.S. Postal Rate Commission, Docket No. R80-1 at 320-22 (Feb. 19, 1981).

periodicals are also circulated through a combination of paid and request subscriptions.

Subscription lists of all ABP member periodicals are always audited by the Audit Bureau of Circulation or Business Publications Audit, each of which audit both paid and request circulation to prevent circulation fraud.

Subscription lists can provide advertisers with some indication of the responsiveness of the readers to the publication, that is, whether the readers are in fact opening the publication and becoming exposed to the advertising inside. This can be shown through the length of time particular readers have subscribed to a periodical. If, year after year, a reader continues to subscribe to a periodical, this is a reliable and verifiable indication that the reader in fact values the contents of the publication.

II. SPECIALIZED PUBLICATION CIRCULATION LISTS ARE WASTING ASSETS WHICH CAN BE ACCURATELY VALUED, AND ARE SEPARATE AND DISTINCT FROM GOODWILL

An intangible asset like a specialized periodical circulation list can cost substantial sums to acquire. Once acquired, it begins to waste away. According to the test established in *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1251 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), a taxpayer who has acquired such an asset and seeks to amortize it carries a dual burden of proving that the intangible asset involved (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy.

As recognized by both the district court and the Third Circuit in the instant case, the useful lives of subscriber lists can be determined with accuracy. Once a list is developed, predictable events will begin to deteriorate its usefulness at a rate that experts in the field can predict. For example, specialized periodical distribution is determined by job title. A list for a targeted publication is composed of occupational categories such as hospital administrators, plant managers, or sales executives, and as particular individuals move on to other positions or other companies, the list's accuracy will decrease unless replacement names of other qualified subscribers are found. In addition to the fact that the useful lives of specialized publication circulation lists can be determined, the value of the lists can also be determined on an case-by-case basis. In almost any situation, the costs incurred in developing the list are readily determinable.

In other situations, the fair market value of a list can be determined where there is a sufficient number of actual transactions, such as rentals, to determine a value. The lists can be used by book publishers to solicit sales of a new book, to announce, through direct mail advertising, an upcoming industry trade show or a seminar on a topic that will be of interest to the subscriber population, or it can be used to disseminate other services and information of value to subscribers, such as electronic data.

The important point is that the most appropriate valuation determination is dependent upon the factual situation in each case. The Third Circuit decision, however, would deprive publishers of the opportunity to establish a value for their subscriber lists in the context of their particular circumstances.

The Third Circuit erroneously adopted a *per se* rule that such lists are not depreciable, stating:

> Customer lists are generally not depreciable when acquired in conjunction with the sale of the underlying business as a going concern. In the context of the sale of a going concern, it is simply often too difficult for the taxpayer and the court to separate the value of the list *qua* list from the goodwill value of the customer relationships/structure.

Pet. App. at 29a. However, specialized business publication circulation lists are used to demonstrate the quality and attractiveness of a readership to advertisers and others who desire access to the readers. The real value of an accurate and well-targeted list, to borrow from the testimony of a witness in the *Donrey* litigation, is as a "machine" to generate advertiser or rental revenue. *See Donrey*, 809 F.2d at 536.

It was not too difficult for the jury below in the instant case and the juries in the *Houston Chronicle* and *Donrey* cases to make factual determinations of value. Factual determinations of value can be made, and by making these determinations income can be better determined and taxed.

CONCLUSION

Because specialized readership lists are wasting assets, with a determinable value separate from the goodwill of the publication, they should be allowed amortization subsequent to acquisition, as was recognized by the Fifth and Eighth Circuits. Any other result would result in an inaccurate determination of the true level of taxpayer income. The goal

of taxation is taxation of net income. If an asset, intangible or tangible, is wasting away, recognition of that fact better matches the income generated by the asset with the costs of producing the income from the asset. *See Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 101 (1943); *Massey Motors, Inc. v. United States*, 364 U.S. 92, 104 (1960). The example of specialized publications demonstrates that the determination of how the amortization can best reflect the underlying economic realities is a fact-specific determination, not amenable to a *per se* rule that would unjustly prevent any consideration of the value of subscriber lists.

Respectfully submitted,

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER COMPANY,
Petitioner

vs.

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE CHARLES SCHWAB CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER.

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No. 91-1135

In the Supreme Court

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NEWARK MORNING LEDGER COMPANY,
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vs.

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE CHARLES SCHWAB CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER.

Pursuant to Rule 37.3 of the Rules of this Court, this brief is respectfully submitted in support of Petitioner by amicus curiae The Charles Schwab Corporation. The parties have consented to the filing of this brief, and their written consents have been filed with the clerk of this Court.

INTEREST OF THE AMICUS CURIAE

The Charles Schwab Corporation is the owner of Charles Schwab & Co., Inc. (hereinafter referred to as "Schwab & Co."), America's largest discount broker. Schwab & Co. has grown from a single San Francisco office in 1974 to over 160 locations throughout the United States. Schwab & Co. serves more than 1.7 million active customer accounts. The growth in customer accounts has come from, in part, acquisition of other discount

brokerage companies or of customer accounts from other brokerages.

In 1981 and 1982, Schwab & Co. made six such acquisitions and claimed depreciation expense deductions for federal income tax purposes regarding the intangible assets it acquired, including customer accounts. This treatment was agreed to by the Internal Revenue Service ("IRS") during audits of Schwab & Co.'s tax returns. Schwab & Co. has relied upon its IRS audit experience and upon 20 years of case law regarding amortization of intangibles in negotiating more recent acquisitions, including the purchase of the entire company in 1987 from BankAmerica Corporation by Charles R. Schwab and a group of employees and other investors. The purchase in 1987 is presently the subject of a petition by The Charles Schwab Corporation to the United States Tax Court in a case in which the government is disputing the depreciation of the acquired intangibles.

INTRODUCTION AND SUMMARY OF ARGUMENT

The Internal Revenue Code and the government's Treasury Regulations require depreciation of wasting assets, including intangibles. The regulations prohibit depreciation of "goodwill," but do not, on their face, define "goodwill." When the Treasury adopted the regulations, however, it incorporated, by reference, the definition that "goodwill" is the residuum remaining after subtraction of all assets capable of being transferred separately from an entire business. This rule was derived directly from the decisions of this Court in *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436 (1893), and of the Eighth Circuit Court of Appeals in *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927). "Goodwill" has this same meaning in normal commercial practice, as evidenced by generally accepted accounting standards.

In the decision below, *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3d Cir. 1991), the Third Circuit ignored *Metropolitan Bank* altogether and paid only cursory attention to *Red Wing Malting Co.* Armed, in consequence, with an incomplete definition, the Third Circuit erroneously concluded that a

separately transferable asset — a subscriber list — constituted goodwill.

In its defense of the Third Circuit, the government argues, in essence, that when it says in its regulations that "goodwill" may not be depreciated, it means to deny depreciation not only to "goodwill", as defined in *Metropolitan Bank* and *Red Wing Malting Co.*, or as used in normal commercial practice, but also to intangibles that can be separately sold. The taxpayer, on the other hand, seeks only to depreciate the subscriber list that it acquired, but not its purchased goodwill.

The government has attempted to justify its position by citing incomplete definitions of the term "goodwill" in or from several cases. However, the government's redefinition of goodwill is not consistent with the definition of the term by this Court, as incorporated by the government into the Treasury Regulations here at issue, readopted in recent Treasury Regulations in another context, and reflected in normal commercial usage.

This Court should hold the government to the definition of "goodwill" the government has already adopted and, in consequence, reverse the Third Circuit and find in favor of the petitioner in this case.

ARGUMENT

I

THE GOVERNMENT HAS ADOPTED, AND HAS RECENTLY CONFIRMED, BY VALIDLY PROMULGATED REGULATIONS, THE "RESIDUAL" DEFINITION OF GOODWILL ENUNCIATED BY THIS COURT AND APPLIED BY LOWER COURTS TO FEDERAL INCOME TAX CASES.

A. The Treasury Adopted The Residual Definition Of Goodwill When It Promulgated The Precursor Of Treasury Regulations Section 1.167(a)-3.

The central feature of this case is the proper interpretation of the italicized sentence of Treasury Regulations Section 1.167(a)-3 shown below:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. *No deduction for depreciation is allowable with respect to goodwill.* [Emphasis added.]

This iteration of the rule that goodwill is not subject to depreciation was adopted by the government, in substantially the foregoing form, in Treasury Decision 4055, VI-2 C.B. 63 (1927), based upon the decision of the Eighth Circuit Court of Appeals in *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927):

> In view of the decision of the Circuit Court of Appeals for the Eighth Circuit, in *Red Wing Malting Co. v. Willcuts, Collector*, dated November 5, 1926 [C.B. VI-1, 225], articles 163 of Regulations 45 (1920 edition), 62, 65, and 69 are hereby amended by the addition thereto of the provision that: "No deduction for depreciation, including obsolescence, is allowable in respect of goodwill." Said articles, as amended, read as follows:
>
> Art. 163. Depreciation of intangible property.—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. No deduction for depreciation, including obsolescence, is allowable in respect of goodwill.[1]

In promulgating Treasury Decision 4055, the government adopted, and is bound by,[2] the rule of *Red Wing Malting Co.* It must follow, since the Treasury Decision was without qualification in this regard, that the adoption was of the whole rule of *Red Wing Malting Co.* More specifically, in *Red Wing Malting Co.*, the court addressed two issues. One was the issue of whether goodwill is depreciable. The other was the definition of goodwill. It would make little sense to announce that depreciation may not be claimed as to "goodwill" without also having or prescribing an understanding of what the "goodwill" is that may not be depreciated. The court in *Red Wing Malting Co.* drew its conclusion that goodwill is nondepreciable from an extended analysis of the

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[1] T.D. 4055. This Regulation has been re-promulgated, with (so far as relevant here) minor language changes, several times to reflect reenactment of, or other changes in, the internal revenue laws. Former Reg. 111, § 29.23(l)-3; Former Reg. 118, § 39.23(l)-3; T.D. 6182, 1956 C.B. (Pt. 1) 98; T.D. 6452, 1960-1 C.B. 127. The government has not made material amendments to Treasury Regulation Section 1.167(a)-3 since 1927. That Regulation, therefore, means today what it meant then.

[2] It is beyond question that federal agencies are bound by their own rules. *Morton v. Ruiz*, 415 U.S. 199, 235 (1974); *Fribourg Navigation Co. v. Commissioner*, 383 U.S. 272, 279-280 (1966) (Commissioner's position in litigation was contrary to long-standing administrative and judicial practice); *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110, 115 (1939) (Commissioner conceded that he was bound "to apply the statute in conformity to the regulation," but argued that subsequent amendment to the regulation had retroactive effect). Further, while the government is free to amend its regulations, it is not free to disregard them, and cannot change the regulation by administrative pronouncement short of a regulation. *R.J. Reynolds Tobacco Co.; Honeywell Inc. v. Commissioner*, 87 T.C. 624, 635 (1986) (Revenue Ruling that was inconsistent with the regulation was of no effect); *Woods Investment Co. v. Commissioner*, 85 T.C. 274, 282 (1985) (Commissioner's reluctance to amend its own regulation did not justify creating a judicial exception).

nature and definition of goodwill. By basing the amended regulation upon *Red Wing Malting Co.*, the Treasury adopted the same analysis and definition.

B. The Definition Of Goodwill, Based Upon This Court's Decision In *Metropolitan Bank* And Upon *Red Wing Malting Co.*, Is That Goodwill Is The Residuum After All Other Assets Have Been Identified.

How, then, did *Red Wing Malting Co.*, and by adopting the rule of that case, the government, define "goodwill?" The definition is in two parts, derived principally from the decision of this Court in *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436 (1893). One part of the definition is that "goodwill" is

> " 'the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices.' Story, Part. § 99" [*Red Wing Malting Co.*, 15 F.2d at 632, quoting *Metropolitan Bank*, 149 U.S. at 446, quoting Joseph Story, *Commentaries on the Law of Partnership* § 99, 157 (Boston, Little, Brown and Co., 4th Ed., 1855).]

The other part of the definition, more significant for present purposes in that it unequivocally resolves the issue in the present case in favor of petitioner, is that goodwill is not a separately identifiable or transferable asset, but is merely an incident of a going concern:

> Goodwill is property of an intangible nature. It differs from such intangibles as patents, copyrights, licenses, and franchises, because, while in a certain sense it inheres in and is used in the business, it is not subject to depreciation, as that term is commonly understood and commonly used in the statutes. The Supreme Court of the United States in

Metropolitan Bank v. St. Louis Dispatch Co., 149 U.S. 436, 446 [parallel cites omitted] says:

> "Undoubtedly, goodwill is in many cases a valuable thing, although there is difficulty in deciding accurately what is included under the term. It is tangible only as an incident, as connected with a going concern or business having locality or name, and is not susceptible of being disposed of independently . . . "[1]
>
> . . .
>
> We have heretofore pointed out that goodwill has no existence separate and apart from an established business. With the termination of that business it is ended. While a capital asset, it is not the subject of purchase, sale or assignment separate from the business itself. It is not an assignable asset distinct from the business. It is different in this respect from such intangibles as patents, contracts or franchises which may be sold. [*Red Wing Malting Co.*, 15 F.2d at 632-33.]

The direct corollary of this definition, to which the government is bound, is that "goodwill" is simply the otherwise unnamed residuum after subtraction of all assets capable of being purchased, sold, or assigned separate from the business itself. This conclusion follows from the re-iteration in the definition that goodwill

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[1] This Court, or the Eighth Circuit, could have cited the following passage from Story for this proposition as well:

> [Goodwill] is certainly not a visible, tangible interest, or a commodity, upon which a definite or fixed allowance can be made; nor, perhaps, would a contract, touching the conveyance thereof, be decreed to be specifically performed in equity. It is not, therefore, strictly speaking, a part of the partnership effects, of which, upon a dissolution thereof, a division can be compelled, unless, indeed, in cases, where a sale of the whole premises and stock will be ordered; and then the good-will will accompany such sale.

Story, *supra*, at 157-58 (footnote omitted).

> is not the subject of purchase, sale or assignment separate from the business. It is not an assignable asset distinct from the business.

The logically inescapable converse is that an asset that can be purchased, sold, or assigned "distinct from the business" is not goodwill. Under this definition, it is irrelevant whether an asset actually is transferred as part of a going business; the asset is not goodwill if it *could* be transferred separate from the business. This proposition follows from the plain language of the definition itself and is supported by the examples given by the court in *Red Wing Malting Co.* of assets that are separately salable — "such intangibles as patents, contracts or franchises." "Such intangibles" are simply not goodwill, and it makes no difference to their status whether they are sold separately or as part of the sale of a going concern.

There is no question that subscriber lists or customer accounts are capable of being purchased, sold, or assigned separate from the business that produced them. These are, therefore, not goodwill within the meaning of *Red Wing Malting Co.* and the government's Treasury Regulations. The association of an asset with "the expectation of continued patronage" is not sufficient to result in its classification as non-depreciable "goodwill." This expectation inheres in many assets: a patented formulation of a popular product, an advantageously located store, a long-term customer contract, attractively decorated premises. Nor is the fact that an intangible asset will produce income and is valued in part based on that income sufficient to result in classification as "goodwill." Business assets generally have value only because of the future income they are expected to produce, and the discounted present value of that future income fixes the worth of the asset.[4] It is only when the element of value under examination is

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[4]A discrepancy between valuation based upon the cost of reproduction and valuation using an income forecast methodology may require closer analysis to determine whether the same assets were valued in each case and whether the valuation techniques were properly applied. *See, e.g.*, Gordon V. Smith & Russell L. Parr, *Valuation of Intellectual Property and Intangible Assets* 144, 244 (New York, John Wiley & Sons, 1989). In the case below the government appears to have generated a low "cost" number by valuing the wrong asset. However, valuation remains, in all events, an issue of fact for the trier of fact.

not separately transferable apart from the business as a whole that it falls within the definition of goodwill enunciated by this Court, confirmed in *Red Wing Malting Co.*, adopted by the Treasury Regulations and, as discussed below, confirmed in later pronouncements by other courts.[5]

C. The Government Has, By Subsequent Regulation, Confirmed Its Adoption Of The Residual Definition Of Goodwill.

In Temporary Treasury Regulations Section 1.367(a)-1T(d)(5)(iii), published in 1986 in Treasury Decision 8087, 1986-1 C.B. 175, the government re-committed itself to the residual definition of goodwill. For purposes of establishing the federal income tax consequences of transfers of property to and among foreign corporations, this regulation defines foreign goodwill as follows:

> Foreign goodwill or going concern value is the residual value of a business operation conducted outside the United States after all other tangible and intangible assets have been identified and valued.

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[5]This formulation is not inconsistent with *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1986), *aff'd per curiam*, 919 F.2d 1492 (11th Cir. 1990). The government there argued that a deposit base was goodwill in part because it only had economic significance in the context of a transfer of assets from a bank to a bank. The Tax Court, relying on *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977), a case involving football player contracts, held that the association of deposit base with the remainder of a bank's business so that it cannot be separately sold except in the special context of bank-to-bank transfers did not result in its classification as goodwill. While the Tax Court stated that "separate transferability" of a deposit base was not required to establish that it is not goodwill, *Citizens & Southern Corp.*, 91 T.C. at 492-493, because of the reference to football player contracts (which are frequently separately transferred) and the undisputed evidence of actual transfers of deposit liabilities of failing banks in *Citizens & Southern Corp.*, it is clear that the court was merely rebutting the government's "mass asset" argument.

Thus, although the government's argument in this case ignores the existence of the residual definition of goodwill, that definition not only exists, but has been adopted and re-adopted by the government itself.

D. The Residual Definition Of Goodwill Is Supported By Substantial Case Law.

A substantial number of cases, including *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), adopt or are consistent with the residual definition of goodwill.

1. Cases Preceding *Houston Chronicle* Adopt The Residual Definition.

The following cases have adopted the residual definition of goodwill in the same manner that *Red Wing Malting Co.* did — by finding that separately transferable assets are not goodwill. Thus, in *Manhattan Brewing Co. v. Commissioner*, 6 B.T.A. 952, 960-61 (1927), the court stated:

> The intangible property which the petitioner asserts is subject to obsolescence consists of goodwill, tradenames, and trade-marks. Such assets have value, but that value is so interwoven with the operation of the business, so much an inseparable part of the going concern to which they appertain, that the ascertainment of such value is difficult and their sale, except as component parts of a going business concern is all but impossible.

In *Joseph Garneau Co, Inc. v. Commissioner*, 8 B.T.A. 1041, 1044-45 (1927), the court stated:

> Goodwill, though constituting property, has no existence as an isolated or segregated capital asset. It is not tangible and does not exist, except as an incident of a going business. It is inherently part and parcel of a going and established business, and of tangible, physical property actively employed in business. It can not be separated from the business and property to which it is attached and be dealt with or disposed of separately. Its value is reflected in the value of the business and property of which it is an inseparable part, and can be realized only upon a sale of the business and property.

> It may be said to be nothing more than an element or factor of the business and property. [Citation omitted.]

In *Norwich Pharmacal Co. v. Commissioner*, 30 B.T.A. 326, 330 (1934), the court stated:

> Goodwill is not susceptible of being disposed of independently, that is, separate and apart from the business to which it attaches. *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436, 446. "Goodwill is the favor which the management of a business wins from the public." It has no existence separate and apart from an established business, and it can not be the subject of a loss except on the termination of the business and the sale of the assets. [Citation omitted.]

In *Pfleghar Hardware Specialty Co. v. Blair*, 30 F.2d 614, 616-17 (2d Cir. 1929), the court stated:

> Goodwill has no existence except in connection with a going business; it cannot be separated from the going business to which it is incident.

To the same effect are *Grace Bros. v. Commissioner*, 173 F.2d 170, 175 (9th Cir. 1949) (quoting *Pfleghar Hardware Specialty Co.); MacDonald v. Commissioner*, 3 T.C. 720, 727 (1944) (quoting *Metropolitan Bank); J.W. Wells Lumber Co. Trust A v. Commissioner*, 44 B.T.A. 551, 558 (1941) ("Goodwill can not be disposed of as an asset independently of the business to which it relates," citing *Metropolitan Bank*); *California Vegetable Union v. Commissioner*, 23 B.T.A. 935, 939 (1931) ("Goodwill has no existence separate and apart from an established business," citing *Red Wing Malting Co.* and quoting from *Metropolitan Bank); Dick & Bros. Quincy Brewing Co. v. United States*, 67 Ct. Cl. 505 (1929), reprinted in VIII-1 C.B. 254, 256 (quoting *Metropolitan Bank, Red Wing Malting Co.*, and *Joseph Garneau Co.); Metropolitan Laundry Co. v. United States*, 100 F. Supp. 803, 806 (N.D. Cal. 1951) (goodwill is "a business asset which, it has been recognized, cannot be disposed of separately from the business itself," citing *Grace Bros.* and *Red Wing Malting Co.);* and *Terminal Co. v. United States*, 296 F. Supp. 1084, 1087 (D. Del. 1969) (quoting *Metropolitan Bank*).

2. *Houston Chronicle* Is Consistent With The Residual Definition.

Although *Houston Chronicle* did not enunciate the residual definition of goodwill, it nonetheless reached a result consistent with that definition by allowing depreciation of the subscriber lists before it. *Houston Chronicle*, 481 F.2d at 1251-52, held that depreciation of customer lists is proper

> if [the] taxpayer sustains his burden of proving that the lists (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy.

This test differs from the residual definition of goodwill only insofar as it requires a taxpayer to make a separate showing that an intangible's *value* is "separate and distinct from goodwill." As shown above, under the residual definition of goodwill as established by this Court and substantial federal income tax authority, an intangible *is* separate from goodwill if it is capable of being separately identified and transferred. Thereafter, a taxpayer should need only to show that the asset has an ascertainable value and a limited useful life. The difference between *Houston Chronicle's* test and the residual definition of goodwill is thus more a matter of emphasis than of substance.

II

COMMERCIAL USAGE, AS REFLECTED IN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, ADOPTS THE RESIDUAL DEFINITION OF GOODWILL.

The Eighth Circuit in *Red Wing Malting Co.*, 15 F.2d at 632-33, referred not only to *Metropolitan Bank* in formulating its definition of goodwill, but also to the "[o]pinions of expert accountants," finding them "not without value in considering the peculiar nature and status of goodwill in business."[6]

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[6] The Eighth Circuit quoted extensively in this regard from Robert H. Montgomery, *Auditing Theory and Practice* (The Ronald Press Co., 1921); William Arthur Chase, *Higher Accountancy Principles and Practice* (Chicago, LaSalle Extension University, 1911); and Henry R. Hatfield, *Modern Accounting* (New York, D. Appleton and Co., 1923).

Commercial usage, as reflected in modern accounting principles, remains significant in determining the continued vitality of the residual definition of goodwill. These principles *require* use of the residual definition. Opinion 16 of the Accounting Principles Board ("APB"),[7] entitled "Business Combinations," requires an acquiring corporation to allocate the purchase price of an acquired corporation among the identifiable assets of the acquired corporation, in an amount equal to the fair market values of those assets; any residuum of purchase price over the fair market values of the identifiable assets is recorded as "goodwill":

> An acquiring corporation should allocate the cost of an acquired company to the assets acquired and liabilities assumed.
>
> First, all identifiable assets acquired, either individually or by type, and liabilities assumed in a business combination, whether or not shown in the financial statements of the acquired company, should be assigned a portion of the cost of the acquired company, normally equal to their fair values at date of acquisition.
>
> Second, the excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets ac-

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[7] In 1926, when the Eighth Circuit decided *Red Wing Malting Co.*, accounting treatises and textbooks were the only authority for accounting standards. Today, accounting standards are set by the Financial Accounting Standards Board ("FASB"). The Securities and Exchange Commission ("SEC"), charged with prescribing "the methods to be followed in the preparation of reports, in the appraisal or valuation of assets or liabilities, [and] in the determination of depreciation and depletion" [Securities Exchange Act of 1934, § 13(b), 15 U.S.C. § 78m(b)(1)], essentially delegated this task to both the FASB and its predecessor, the APB. SEC Financial Reporting Release, § 101.

quired less liabilities assumed should be recorded as goodwill.

Business Combinations, Accounting Principles Board Opinion No. 16, ¶ 87 (2 Financial Accounting Standards Board, 1991).[8]

APB Opinion 17, "Intangible Assets", reiterates:

> An enterprise may acquire intangible assets from others or may develop them itself. Many kinds of intangible assets may be identified and given reasonably descriptive names, for example, patents, franchises, trademarks, and the like. Other types of intangible assets lack specific identifiability. Both identifiable and unidentifiable assets may be developed internally. Identifiable intangible assets may be acquired singly, as a part of group of assets, or as part of an entire enterprise, but unidentifiable assets cannot be acquired singly. *The excess of the cost of an acquired company over the sum of identifiable net assets, usually called goodwill, is the most common unidentifiable intangible asset.*

Intangible Assets, Accounting Principles Board Opinion No. 17, ¶ 1 (2 Financial Accounting Standards Board, 1991) (emphasis added).[9]

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[8]This methodology corresponds to that required in allocating the purchase price of a business among the assets acquired for federal income tax purposes. 26 U.S.C. § 1060; Temp. Treas. Reg. §§ 1.338(b)-2T(b)(2), 1.1060-1T(d); *R.M. Smith, Inc. v. Commissioner*, 591 F.2d 248 (3d Cir. 1979).

[9]The Tax Court, in *Staab v. Commissioner*, 20 T.C. 830, 840 (1953), adopted virtually the same definition:

> Good will may be defined by the following formula: Good will equals a-b, where "a" is capitalized earning power and "b" is the value of assets used in the business. Good will, then, is an intangible consisting of the excess earning power of a business. A normal earning power is expected of the business assets, and if the business has greater earnings, then the business may be said to have good will. This excess in earning power may be due to any one or more of several reasons, and usually this extra value exists only because the business is a going concern, being successful and profitable.

These accounting rules, adopted in August 1970, thus continue to embody the residual definition of goodwill enunciated by this Court in *Metropolitan Bank*, applied for federal income tax purposes by the Eighth Circuit in *Red Wing Malting Co.*, and adopted by the government, first in T.D. 4055 and most recently in Temporary Treasury Regulations Section 1.367(a)-IT(d)(5)(iii). If an asset—such as a subscriber list—is identifiable, it is not goodwill. If it is separately transferable, it is not goodwill.

III

THE COURT BELOW OVERLOOKED THE RESIDUAL DEFINITION OF GOODWILL ESTABLISHED BY *METROPOLITAN BANK*, *RED WING MALTING CO.*, AND TREASURY REGULATIONS, ERRONEOUSLY ADOPTING A RULE INCONSISTENT WITH THAT DEFINITION.

An intriguing feature of *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3d Cir. 1990), is that, while it cited *Red Wing Malting Co.*, it unaccountably failed to discuss that case or otherwise take into account the substantial body of case law discussed above following the residual definition of goodwill enunciated by this Court in *Metropolitan Bank*.[10]

Instead, *Newark Morning Ledger* relied for its definition of goodwill upon lower court decisions that had themselves lost touch with the line of cases spearheaded by *Metropolitan Bank*. The Third Circuit thus defined goodwill

> as "the expectancy that old customers will resort to the old place," *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963), and as "the expectancy of continued patronage, for

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[10]This failure is perhaps particularly noteworthy, since the Third Circuit, in footnote 4 of *Newark Morning Ledger*, 945 F.2d at 559, acknowledged that the change in regulations effected by Treasury Decision 4055 "followed the decision in *Red Wing Malting Co.*," but then, in footnote 5, *id.*, complained that "neither Congress, the Treasury, nor the Service has seen fit to promulgate a uniform or coherent definition of the term [goodwill]."

whatever reason," *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962). [945 F.2d at 559.]

Killian relied for the quoted proposition solely upon *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897 (5th Cir. 1962), which in turn relied upon — not *Metropolitan Bank, Red Wing Malting Co.*, and the numerous federal income tax cases deriving therefrom — but *Didlake v. Roden Grocery Co.*, 49 So. 384 (Ala. 1909), a case involving an effort of the estate of a deceased partner to "set aside a sale of the partnership's assets to a corporation composed in part of the surviving partners." 49 So. at 385. Moreover, while the court in *Didlake* did recite the definition of goodwill quoted by *Killian*, 49 So. at 386, it also recited a form of the residual definition of goodwill, 49 So. at 387:

> the authorities are clear to the effect that if a business is sold out entirely, and nothing is said about good will, it goes with the property. This necessarily follows from the fact that good will cannot exist except in connection with the business.

Killian omitted this part of the definition.

Boe relied upon part of the definition of goodwill in *Grace Bros.*, but did not mention the important qualification noted by the court in that case that "[g]ood will has no existence except in connection with a going business; it cannot be separated from the going business to which it is incident." *Grace Bros.*, 173 F.2d at 175, quoting *Pfleghar Hardware Specialty Co.*, 30 F.2d at 616.[11]

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[11]The more extensive list of supporting authorities cited by the Third Circuit at 945 F.2d at 565-66 suffers from the same defect. For example, *Brooks v. Commissioner*, 36 T.C. 1128, 1133 (1961), relied solely upon *Watson v. Commissioner*, 35 T.C. 203 (1960), which relied in part upon *Horton v. Commissioner*, 13 T.C. 143, 148 (1949), which took *its* definition of goodwill from " 'Words and Phrases,' vol. 18, p. 351." *Watson* also relied upon a definition set forth by "Judge Cardozo in *In Re Brown*, 242 N.Y. 1, 150 N.E. 581 (1926)." 35 T.C. at 213. *Skilken v. Commissioner*, 420 F.2d 266, 270 (6th Cir. 1969), cites *Burke v. Canfield*, 121 F.2d 877, 880 (D.C. Cir. 1941), which relies upon *Washburn v. National Wall-Paper Co.*, 81 F. 17, 20 (2d Cir. 1897), which cites no authority, and makes a "cf" reference to *Metropolitan Bank*, 121 F.2d at 880, n. 2. *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 681 (5th Cir. 1971) cites *Killian, Nelson Weaver Realty Co., Boe*, and *Karan v. Commissioner*, 319 F.2d 303, 306 (7th Cir. 1963). *Karan* relies soley upon *Brooks*. A common thread in this "phalanx," 945 F.2d at 565, of cases is that they all, by one means or another, avoided the rule of *Metropolitan Bank* and *Red Wing Malting Co.* The definition of goodwill in the "mass asset" or "indivisible asset" cases similarly does not derive from either *Metropolitan Bank* or *Red Wing Malting Co.* For example, one of the lead "mass asset" cases, *Golden State Towel and Linen Service, Ltd. v. United States*, 373 F.2d 938 (Ct.Cl. 1967), relies primarily on *Thrifticheck Service Corporation v. Commissioner*, 287 F.2d 1 (2d Cir. 1961), *Danville Press, Inc. v. Commissioner*, 1 B.T.A. 1171 (1925), and *Boe*. Both *Thrifticheck* and *Danville Press* were failure of proof cases which do not set forth definitions of goodwill. *Golden State Towel* does go on to recite that goodwill equals expectancy of continued patronage equals customer lists, but cites no authority for the proposition other than *Michaels v. Commissioner*, 12 T.C. 17 (1949), which finds as a fact in the circumstances of that case that " 'Good will' and the customers' lists were substantially the same."

In short, *Newark Morning Ledger* armed itself with an incomplete definition of goodwill and, partly in consequence, reached an incorrect result. Had the Third Circuit reviewed the substantial line of cases derived from *Red Wing Malting Co.*, which it cited in connection with Treasury Regulations Section 1.167(a)-3 but apparently did not otherwise analyze, it should have reached the conclusion that a subscriber list, or any asset capable of being transferred separately and not merely as part of a going concern, is not goodwill and is depreciable upon a reasonable showing of value and useful life.

IV

THE GOVERNMENT'S ARGUMENT IN THIS CASE IS BASED UPON AN INCOMPLETE DEFINITION OF "GOODWILL."

In its Brief regarding the Petition for Writ of Certiorari in this case, the government, like the Third Circuit, relies upon a fatally incomplete definition of "goodwill." At page 10 of its Brief, the

government cites *Metropolitan Bank*, 149 U.S. at 446, but only for the proposition that

> Goodwill may be attributable to a business's location, its age, the superiority of its products or services and any other factor that blesses it with a favorable name and reputation, helping to attract "constant or habitual customers."

The government overlooks the rest of the definition of "goodwill" in *Metropolitan Bank*, *Red Wing Malting Co.*, the substantial body of federal income tax cases adopting the residual definition of goodwill, and its own regulations adopting the same definition.

In effect, the government is, by indirection, asking this Court to limit its decision in *Metropolitan Bank* and rescue the government from the consequences of having adopted the full *Metropolitan Bank* rule in its own regulations. If the government wants to expand its definition, it has the power to do so by amending its regulations according to regular administrative processes. It should not seek to do so in this forum.

CONCLUSION

This Court's definition of goodwill in *Metropolitan Bank*, as adopted by *Red Wing Malting Co.*, by a substantial number of other cases, and by the government itself in its own Treasury Regulations, remains valid and should be adhered to. The decision below should be reversed in light of those authorities.

Respectfully submitted,

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